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# The Impact of Securities Laws on Developing Companies: Would the Wright Brothers Have Gotten Off the Ground?

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ESSAY

THE IMPACT OF SECURITIES LAWS ON DEVELOPING COMPANIES: WOULD THE WRIGHT BROTHERS HAVE GOTTEN OFF THE GROUND?

by  
Stuart R. Cohn\*

*Suppose the Wright brothers, to pursue their dreams of manned flight, needed outside financing. Confronted with the intimidating regulatory requirements of today's state and federal securities laws, would they ever have gotten off the ground? With historical illustrations, this Essay presents an entertaining look at the serious problems that would be encountered today by entrepreneurs who have ideas but need capital to develop them. It analyzes the regulatory maze and prohibitions of state and federal securities laws and concludes that, in today's marketplace, the Wright brothers probably would have violated several laws to obtain essential financing for their venture.*

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I. INTRODUCTION

The Wright brothers never contended with federal or state securities laws. The first heavier-than-air flying machine was conceived, financed, and developed between 1899 and 1903, a decade before state securities laws appeared and thirty years before the federal government's entrance into the field.

I will not suggest that history would have been different had securities laws existed during the Wright brothers' inventive period. Quite the contrary. These Dayton, Ohio siblings needed no outside financial help.<sup>1</sup> They developed their ideas through homemade experiments. The wind tunnel built in their bicycle shop was constructed from a used starch carton, yet it produced results more accurate than those developed by renowned European scientists. The costs connected with development of the motor, wings, struts, elevators, and tail sections of their novel aircraft, as well as the experimental North Carolina flights, were borne by the two brothers from family resources and the profits of their bicycle shop.

But what if they had needed financial help? And what if our current securities laws were in place when the experiments were at their peak? I have answered those questions through a three-act drama presented below. The story does not have a happy ending. Indeed, it suggests that the spectacular invention of the aeroplane might not have occurred in the same manner, at least not for the Wright brothers. If they needed to raise capital under today's conditions, they would have been met with a

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<sup>1</sup> The description of the Wright brothers' inventive efforts set forth in this account are taken from a variety of sources. Except for the assumed financing problems and attorney Horace Alexander, the account of the brothers' development of the airplane is factually true. A concise history of airplane development appears in OMEGA G. EAST, WRIGHT BROTHERS NATIONAL MEMORIAL, NORTH CAROLINA (1976). Other sources reflected in the following account are TOM D. CROUCH, THE BISHOP'S BOYS: A LIFE OF WILBUR AND ORVILLE WRIGHT (1989); FRED KELLY, THE WRIGHT BROTHERS: A BIOGRAPHY AUTHORIZED BY ORVILLE WRIGHT (1943); and PATRICK B. NOLAN, THE WRIGHT BROTHERS COLLECTION (1977).

plethora of statutes and regulations, both federal and state, that could only have impeded and frustrated their efforts.

The dramatized problems encountered by the Wright brothers are commensurate with those faced by today's entrepreneurs who possess ideas and energy but lack the capital to develop, experiment with, and market their inventions. One should not suppose, however, that the Securities and Exchange Commission (SEC) is averse to reform in this area. On the contrary, there are numerous recent rule changes designed to improve the lot of small companies.<sup>2</sup> The problem with such efforts is their quality, not their quantity. The SEC reforms have failed to alleviate significant regulatory problems for developing companies that do not have ready access to capital markets or venture capital firms. Every registration exemption, except one, is laden with technical provisions that substantially impair the exemption's attraction. The one exception, Rule 504,<sup>3</sup> has its own defects. It is limited in the offering amount, and because of incompatible state standards, it cannot be utilized in most states without state registration.<sup>4</sup>

The SEC knows well the regulatory problems facing small companies. Its Office of Small Business is devoted to the analysis of the securities laws' impact upon small-business capital development.<sup>5</sup> The Commission's staff faces an annual critique and recommendations from participants at the SEC-sponsored Forum on Small Business.<sup>6</sup> It is therefore both ironic and disappointing that the Commission appears to be devoting its greatest attention to easing processes for large, well-financed enterprises that have little difficulty raising capital on their own terms and

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<sup>2</sup> Recent reforms include permitting a "testing of the waters" for Regulation A offerings; the elimination of most Regulation D offering conditions for Rule 504 offerings; the development of the Form SB-1, a more user-friendly registration statement for small issuers; a substantial compliance provision added to Regulation D; and recognition through Rule 1001 of a state-oriented accredited investor exemption. These reforms are described and discussed in further detail below.

<sup>3</sup> Rule 504, 17 C.F.R. § 230.504 (1999). Rule 504 permits eligible issuers to raise up to \$1 million every twelve months without offeree, purchaser, disclosure, or offering limitations. *See infra* note 39.

<sup>4</sup> *See infra* note 39.

<sup>5</sup> The Office of Small Business is part of the Division of Corporation Finance. Securities & Exch. Comm'n, *Q&A: Small Business and the SEC* (visited Oct. 8, 1999) <<http://www.sec.gov/smbus/qasbsec.htm>>.

<sup>6</sup> Each year the SEC sponsors an annual SEC Government-Business Forum on Small Business Capital Formation. Participants include entrepreneurs, attorneys, venture capitalists, securities industry specialists, and academics. The Forum develops a list of specific recommendations to the SEC that invariably includes significant modification or elimination of exemption conditions. In addition, since 1996, the SEC has hosted numerous SEC Small Business Town Hall Meetings in various locales to discuss capital formation issues. Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Exchange Act Release No. 33-7644, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,114, at 81,774 n.39 (Feb. 25, 1999). The common theme in all of these forums is one of over-regulation and the difficulties faced by small companies in complying with the technical conditions of registration exemptions.

timetables. The SEC recently issued perhaps the largest proposed set of regulations in its history, so large that it was dubbed the "Aircraft Carrier" proposal.<sup>7</sup> The proposal affects registration statements, underwriting responsibilities, communications before and during the offering periods, and a host of related subjects that ease restrictions on so-called "seasoned issuers," those that are publicly held or are already public reporting companies. For small companies—the ones that truly need regulatory reform efforts—the proposal offers only a few inconsequential bones.<sup>8</sup> The "Aircraft Carrier" proposal is likely to dominate the SEC's attention for the foreseeable future, leaving unaddressed the plight of smaller companies.

Critique of the securities laws does not stem from concerns of under-regulation or oversight. On the contrary, the federal securities laws are remarkably broad and effective. One commentator has noted that the U.S. securities laws are "at their zenith in terms of their demands and protection of investors," providing "a pure and pristine image of the wonderful protective benefits that can arise through government regulation."<sup>9</sup> His comments, however, are intended as faint praise. Professor Cox appropriately argues that market changes, especially the globalization of securities offerings, require "wholesale review and deregulation" of our securities laws.<sup>10</sup> The deregulation argument based on technological and marketing developments is equally supported from an entirely different perspective, namely the concern for capital-raising difficulties of young and start-up enterprises.

The drama that follows examines securities laws from the perspective of a developing company. The semifictional account describes the securities laws problems that the Wright brothers might have faced had they needed financing. My purpose goes beyond fantasy: It is directed at the serious need for reform of registration exemptions and, indeed, the regis-

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<sup>7</sup> The Regulation of Securities Offerings, Exchange Act Release No. 33-7606A, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,108 (Nov. 13, 1998) [hereinafter Regulation of Securities Offerings]. The magnitude of the proposals, as well as substantial criticism regarding their effect upon certain types of capital-raising, has led the SEC to consider substantial revision and reproposal. See *Aircraft Carrier Likely to See Reproposal, SEC Official Tells Bar Group; M&A on Target*, 31 Sec. Reg. & L. Rep. (BNA) 1065 (Aug. 13, 1999).

<sup>8</sup> Regulation of Securities Offerings, *supra* note 7. Proposals affecting smaller issuers relate to delaying the time that registration fees must be paid, allowing incorporation by reference for previously filed SEC reports, permitting increases in the size of registered offerings on an expedited basis, and permitting earlier use of the private offering exemption following a withdrawn registered offering. None of these changes materially affect the capital-raising problems facing many small companies.

<sup>9</sup> James D. Cox, *Rethinking U.S. Securities Laws in the Shadow of International Regulatory Competition*, LAW & CONTEMP. PROBS., Autumn 1992, at 157, 198.

<sup>10</sup> *Id.* at 198. Professor Cox suggests that the data reflect a relative imbalance between the unwillingness of foreign companies to subject themselves to U.S. securities laws and the willingness of U.S. companies to utilize overseas markets. *Id.* at 183.

tration process itself. Statutory requirements created more than sixty years ago in a markedly different economic environment, and regulations based upon those requirements, do not adequately address capital formation problems in today's technology-driven and capital-intensive business world. Registration has long reigned as the dominant statutory requirement and default procedure for broad-scale securities offerings. Time, experience, and technology make it appropriate to consider whether securities laws based on a registration process have "reached a point of twilight,"<sup>11</sup> as suggested by one commentator. Following the Wright brothers' saga, this Essay considers policy concerns and recommends reforms to facilitate capital funding by start-up and developing businesses.

## II. THE STORY

### *Act I, Scene 1: The First Visit to Their Lawyer, April 1900*

It was a short walk from Orville and Wilbur's bicycle shop to the law office of Horace Alexander. The snows were receding from the streets of Dayton on this sunny morning in April 1900, as the two brothers strode swiftly to their meeting.

Orville had earlier alerted Horace Alexander to their purpose. When the two brothers entered Horace's small office, Horace had on his desk a copy of both the federal Securities Act of 1899 and the Ohio Securities Law of 1896.<sup>12</sup> Both statutes were borrowed from the County Library, as Horace knew of no attorney in Dayton who was familiar with these new laws.<sup>13</sup> Orville was the more outspoken of the two, despite being four years junior to his brother. His early ventures in the printing business, starting at age thirteen, gave him a sense of business understanding not shared by Wilbur. Orville began the discussion by defining the goal as follows:

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<sup>11</sup> Joel Seligman, *Götterdämmerung for the Securities Act?*, 75 WASH. U. L.Q. 887 (1997). Professor Seligman suggests that there has been a shift in ideology from the early concern about fraud to the current concern that "the cost of registration . . . no longer can be justified." *Id.* at 901.

<sup>12</sup> The dates of both the Securities Act of 1933 and the Ohio securities law have been changed for purposes of this fictional account. Ohio's initial securities laws were adopted in 1913. See 1913 Ohio Laws 743.

<sup>13</sup> The lack of experience and knowledge about the securities laws remains today among many lawyers and is reminiscent of Prof. David Ratner's hilarious (and perhaps apocryphal) *Letters from a Kentucky Lawyer*, in DAVID L. RATNER & THOMAS L. HAZEN, *SECURITIES REGULATION, CASES AND MATERIALS* 342-44 (5th ed. 1996). A Kentucky lawyer writes to the SEC (in response to an SEC inquiry) that "[t]here are a dozen lawyers in this town, and I would not give two cents for what all of us put together know about Federal laws. . . . If some poor fellow comes in with a Federal problem, I tell him to write his Congressman." *Id.*

They needed approximately \$1.5 million<sup>14</sup> to construct several man-carrying gliders, to transport the gliders to the site in North Carolina they had selected for experiments,<sup>15</sup> and to finance those experiments over several months. The two brothers had already formed the Wright Flying Machine Company and were prepared to sell stock to raise the necessary funds.

On a single sheet of paper Orville set forth the proposed budget. On the right side, under "Receipts," were three figures. One was \$300,000, an amount promised to them by Octave Chanute, the leading American authority on aviation science and an avid correspondent and supporter of the two brothers.<sup>16</sup> The second item was \$100,000, a promise from their close boyhood friend, Cordy Ruse, who in 1896 built the first horseless buggy seen on the streets of Dayton. The goal now was to raise the additional \$1.1 million, the third figure in that right-hand column.

"What do you have in mind for raising the rest?" asked Horace.

"We figured we could raise most of it right here in Dayton," Orville answered. "We don't know anyone who could give us a large amount, but lots of people know us and might be willing to put in small amounts. If we put together a nice little pamphlet, we could probably interest quite a few people. Our good friend Lou Poston, a stockbroker over at Daniel & Sons, told me that he'd try to get his company to help us raise the money."

"The other question I've got, boys, is whether you foresee any profit coming from this project. I mean, why would someone invest in your company?"

The question caught the brothers short. Profit was not the motivation of either Orville or Wilbur. The bicycle shop provided them a steady income, they lived in their father's home, and neither had a spouse or family to support. Since their childhood days, when they spent countless hours duplicating ever-larger models of a toy that lifted itself into the air

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<sup>14</sup> The dollar figures used in this drama are clearly inappropriate for 1900 standards and do not reflect actual facts. The figures have been chosen to relate to existing monetary limits in registration exemptions. It has been estimated that the Wright brothers' total costs to develop and fly their first plane were less than \$1,000. KELLY, *supra* note 1, at 112.

<sup>15</sup> The brothers sought an experimental site that was both isolated and sandy and that offered strong, constant winds. They studied a table of average hourly wind velocities recorded at 120 U.S. Weather Bureau stations. Kitty Hawk, North Carolina, a little-known place at the time, was selected as the most suitable site. CROUCH, *supra* note 1, at 182.

<sup>16</sup> Octave Chanute was a Frenchman who emigrated to the United States and whose principal occupation involved building railroads and railroad bridges. He became fascinated by the possibility of flight in his later years and established a glider camp on the sand dunes of Lake Michigan. The data he accumulated were used extensively by the Wright brothers, with whom he was in frequent correspondence. He visited Kitty Hawk on several occasions during the early period of the Wrights' experiments.

with the help of a wound-up rubber band, the brothers had been fascinated by the possibility of flight. Otto Lilienthal's glider experiments in Germany were widely reported and had piqued their growing interest.<sup>17</sup> Curiously, it was the failures of others that intrigued them the most. Several of the great pioneers of flight were killed in glider flights or simply gave up. The insoluble problem, thus far, was maintaining the glider's equilibrium in varying wind conditions. Both Orville and Wilbur perceived the problem as not too dissimilar from understanding the forces controlling a bicyclist's balance, especially when turning corners. What began as late night discussions regarding centers of gravity had eventually evolved into small, scale-model gliders. It was the challenge of maintaining airborne equilibrium that kept their interest going, not the thought of personal profit.

Nevertheless, they both realized that a company without a profit potential would not attract investors. Wilbur therefore recounted what Octave Chanute had told them of the interest shown by the U.S. Army in a piloted flying machine. Surveillance of military fields by balloon flights was too limited by weather and wind conditions to be dependable. A manned glider that could soar at a substantial height and remain aloft for minutes at a time held considerable promise for reconnaissance operations. The French and English governments were similarly impressed with the military potential for such machines. Wilbur added some speculative ideas of his own, such as flights over rivers and impassable areas.

"Will the figure you mentioned, \$1.5 million, be enough to get you through all of the experimental stages?" Horace inquired.

"Not all of them," replied Orville. "If all goes well in North Carolina, we will be ready to build a motor-powered machine that will supply its own lifting force. We'll need more money then, and surely more experiments, but how much and for how long, we're just not sure at this time."

Orville and Wilbur were all too familiar with the danger of going into a venture with too little capital. Ten years earlier, their newspaper, *The Evening Item*, went out of business less than four months after its first publication. They realized in hindsight that they had begun with too little capital to compete against the dozen newspapers already existing in Dayton. For this venture, larger by far, they would need substantial financial commitments.

"Where does Octave Chanute reside?" asked Horace.

"In Chicago."

"Any other prospects?"

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<sup>17</sup> Otto Lilienthal was the most eminent scientist in the world working on the development of manned flight. His book on bird flight, *DER VOGELFLUG ALS GRUNDLAGE DER FLIEGEKUNST* (1889), and his essays on glider flights in 1894 were the recognized authorities on aeronautics. He made several hundred successful glider flights but was killed in such a flight in 1896.



"Octave tells us that he's got friends in New York who could give us some money," answered Orville. "As for the rest, we've sold a lot of bicycles since '93 and repaired a lot, too. Those people know us well and might be willing to put some money into this project. And we've got lots of connections in the Church, both here and in Indiana."<sup>18</sup>

"How soon do you need the money?" inquired Horace.

"As soon as possible, especially if we're going to get to North Carolina before winter sets in."

Horace was silent for a few seconds. Measuring his words carefully, he said, "Boys, I need to be frank with you. I've never handled a matter under these new securities laws. And I don't know anyone in Dayton who has. From what I've read, the laws are complex and strict. There's no room for error, and both the federal and state authorities can stop your offering if you're not in full compliance with every jot and tittle of the law. From what you're telling me, you're planning to raise more money down the line. If we do something wrong on this offering, we might not get a second chance. I'm going to need some time to digest all of this and figure out what you can and cannot do. I know that time is precious, but with these laws we can't afford to make a mistake. Give me a little while to do some thinking and make some inquiries. I'll get back to you as soon as I'm able."

Orville and Wilbur were uncharacteristically silent on their walk back to their shop. Wilbur was lost in thought about the size and shape of the rear stabilizer he had been sketching. Orville was wondering why their attorney seemed so worried. Why should government agencies be concerned with this venture? He and his brother were asking for voluntary investments, not planning to rob a bank.

*Act I, Scene 2: Later, the Same Day*

As Orville was pondering the mysteries of the securities laws, Horace Alexander was musing over policy. He remembered that there were quite a few scandals in the past twenty years by traveling salesmen who enticed unsuspecting and trusting investors to part with their money in return for a gilt-edged certificate representing a stake in the growing corporations back East. Unfortunately, some of those corporations were nonexistent, and some that existed had little more than the certificates themselves as assets. Investors' money often got no further east than the salesmen themselves, who were last seen on trains heading toward the setting sun.

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<sup>18</sup> The Wright brothers' father, Milton W. Wright, became bishop of the United Brethren Church in 1878, which caused him to move his family from Dayton, Ohio, to Cedar Rapids, Iowa. The family moved back to Dayton in 1884, when Bishop Wright became editor of "Religious Telescope," a church publication.

It took several years for purchasers to realize that the promises and certificates had about as much substance as so many feet of blue sky.<sup>19</sup> The losses led to a call for protection. Kansas enacted the first statute regulating the offer and sale of securities.<sup>20</sup> Within twenty years, nearly every state in the union had enacted a form of "blue sky" law.<sup>21</sup> The statutes were fairly uniform, most requiring advance state registration of securities to be sold, licensing of sales personnel, and civil and criminal penalties for registration or fraud violations.<sup>22</sup>

Horace scanned through the Ohio statute, hoping to see exceptions to the registration requirement. What he found was not encouraging. An exemption existed for offerings that met the federal private offering exemption.<sup>23</sup> The Wright brothers also could avoid registration in Ohio if they limited their sales in the state to not more than ten people.<sup>24</sup> Ohio also had adopted the Uniform State Limited Offering Exemption (ULOE), based in large measure on the Rule 505 federal exemption.<sup>25</sup>

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<sup>19</sup> Hence the name, Blue Sky legislation, to refer colloquially to state securities statutes. The origin of the term is uncertain. In *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917) (second internal quotations omitted), the Court referred to such legislation as attempting to curb promoters from selling interests having no more substance than "so many feet of 'blue sky.'"

<sup>20</sup> See Act of Mar. 10, 1911, ch. 133, 1911 Kan. Sess. Laws 210, entitled "AN ACT to provide for the regulation and supervision of investment companies and providing penalties for the violation thereof."

<sup>21</sup> Nevada was the sole exception. See 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 39 (1989).

<sup>22</sup> State blue sky legislation may have been motivated in part by other than public protection concerns. Securities filings and fees generate considerable state revenue, often well in excess of enforcement and administrative expenses. Blue Sky laws mandating filings and fees offered an easy revenue-creating process. See *id.* at 150 (citing North American Securities Administrators Association 1984 Study); see also Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 351 (1991-1992)

[O]ur research reveals that while many proponents of the blue sky laws were attempting to advance the public interest as they perceived it, the statutes themselves were invented, and thereafter promoted in the legislative process, by defined vested interests, including the owners of smaller banks and savings institutions who saw blue sky legislation as a means for suppressing competition for depositors' funds.

*Id.*

<sup>23</sup> See OHIO REV. CODE ANN. § 1707.03(Q) (West Supp. 1999). The National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, 110 Stat. 3416 (1996), amended section 18 of the 1933 Securities Act, 15 U.S.C. § 77r(b), to create a class of "covered securities" for which state registration provisions are preempted. Among the covered securities are offerings made pursuant to Rule 506, 17 C.F.R. § 230.506 (1999), the federal private offering exemption. See 15 U.S.C. § 77r(b)(4)(D). Rule 506 offerings are discussed *infra* note 44.

<sup>24</sup> See OHIO REV. CODE § 1707.03(O)(b).

<sup>25</sup> See *id.* § 1707.03(W). Rule 505, 17 C.F.R. § 230.505 (1999), is discussed *infra* note 61 and accompanying text. In general, Rule 505 permits offerings within a twelve-month period valued up to \$5 million, provided there are not more than thirty-five nonaccredited investors. Other conditions include disclosure requirements and

That exemption was limited to thirty-five nonaccredited investors,<sup>26</sup> and Horace wondered whether that limitation would fit the Wright brothers' needs. Ohio also had recently adopted an exemption for offerings limited to accredited investors.<sup>27</sup> "Accredited investors" was a new term to Horace, but he found it defined in Rule 501 of Regulation D and saw that it referred principally to institutional and wealthy investors.<sup>28</sup> Horace noted that one of the advantages of this exemption was that it permitted a general announcement of the offering,<sup>29</sup> a form of solicitation that none of the other Ohio exemptions permitted. Nevertheless, Horace doubted that Orville and Wilbur could raise enough money just from accredited investors. He knew from experience with his few well-to-do clients that they were conservative in their investments, or at least they would have substantial doubts about a venture as risky and uncertain as the aeroplane development.

If the Wright brothers decided to register their offering in Ohio, Horace knew that he could put together a prospectus that would satisfy Ohio's disclosure requirements. What concerned him, though, was the statutory provision that permitted the state administrator to reject the registration application on grounds that the offering was "on grossly unfair terms."<sup>30</sup> This so-called merit review concept was a central element in most state statutes.<sup>31</sup> It was considered an important protection against flimflam offerings that had seduced gullible citizens in the prestatute

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limitations on the manner of offering. The Uniform Limited Offering Exemption (ULOE) added some requirements, including a suitability requirement for purchasers, although that particular requirement is not included in the Ohio statute. See OHIO REV. CODE § 1707.03(W).

<sup>26</sup> See OHIO REV. CODE § 1707.03(W). Rule 505 allows no more than thirty-five nonaccredited purchasers of the securities. See *infra* note 62 for a definition of accredited investors.

<sup>27</sup> See OHIO REV. CODE § 1707.03(Y).

<sup>28</sup> Rule 501, 17 C.F.R. § 230.501 (1999).

<sup>29</sup> See OHIO REV. CODE § 1707.03(Y)(6). The announcement must be limited to a brief description of the issuer's business and the security to be issued.

<sup>30</sup> *Id.* § 1707.09(K).

<sup>31</sup> "Merit review" remains a component of the securities laws of most states, although in differing forms. The traditional "fair, just, and equitable" standard is found in approximately twenty states. Most states authorize denial of registration if the administrator finds that the offering may tend to work a fraud upon investors. See, e.g., IOWA CODE ANN. § 502.209(1)(e) (West 1998). Fraud often is defined in administrative regulations, many of which adopt North American Securities Administrators Association (NASAA) guidelines on pricing, options, cheap stock, capitalization, and other factors. For example, the guideline regarding promoters' investment requires that initial and early investors have an equity investment equal to at least 10% of the proposed offering. If the Wright brothers had been raising \$1.5 million, their personal investment would have to have been \$150,000, an amount perhaps beyond their reach. Some states require an even higher percentage of investment by promoters. See, e.g., Florida, FL. ADMIN. CODE ANN. r. § 3E-700.005 (1998) (if the ratio of promoters' equity to total equity is less than 15%, the offering is not considered fair, just, or equitable unless the offering has a firm commitment underwriter and the issuer's net worth exceeds \$100,000).

days. Review by knowledgeable state employees would, it was hoped, limit offerings to only those who had strong economic viability.<sup>32</sup> Horace understood its purpose and approved protecting the unsophisticated from financial follies, but he had concerns that Ohio administrators might not look favorably upon his clients' novel and financially uncertain venture. Would the administrators regard an offering as "grossly unfair" where most of the capital would be provided by outsiders who would have no control over the company, the two indispensable principals were continually risking their lives, and there was no evidence of any market for the aeroplane even if (and it was an enormous "if") a machine ever got off the ground? Given the excellent chance that every penny invested would be lost, Horace feared that the offering would be viewed as grossly unfair.<sup>33</sup>

Horace settled upon writing a letter to Nathan Gooding, the state representative from Dayton's district. Horace explained his concern and asked Nathan to inquire at the securities division about its policy regarding merit review of new and untried ventures. Perhaps some advance notice and discussion could allay problems. Horace posted the letter and turned his attention to federal law.

*Act I, Scene 3: Several Days Later*

The *Dayton Morning Sun* was Horace's morning habit, along with fried eggs and hash brown potatoes at Molly's Grill. Several days after his initial meeting with Orville and Wilbur, Horace was more than a little startled to read an advertisement in the *Sun* announcing "a bold and exciting venture, to wit, the development by Orville and Wilbur Wright of a motor driven, man-carrying flying machine." The advertisement stated, "The Wrights are looking for interested investors for the Wright Flying Machine Company, an adventure of unparalleled dimensions. You are invited to call at our establishment at 1127 West Third Street, City, for further details."

Orville was opening the cycle shop when Horace arrived, newspaper in hand.

"Orville," Horace asked in a deceptively calm manner, pointing to the advertisement, "what's this all about?"

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<sup>32</sup> Considerable debate exists regarding the efficacy and justification for merit review. See, e.g., Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79; Hugh H. Makens, *Who Speaks For the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435 (1984); James S. Mofsky & Robert D. Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367 (1977).

<sup>33</sup> See Milton C. Boesel, Jr., *Analysis of the Ohio Securities Act*, 5 W. RES. L. REV. 352, 357 (1954) ("By the use of this flexible phrase, issues which technically comply with the provisions of the Act and do not involve fraud may nevertheless be prohibited if the Division feels the terms are not in the best interest of the public." (emphasis added)).

"Nothing much, Horace," Orville replied nonchalantly. "We have to get started before winter sets in and thought that we should line up some interested investors. Don't worry, we won't sell them anything without your approval. We printed some little information sheets for anyone interested. In fact, we've already given out about a dozen to some customers."

"Orville," responded Horace, "I hate to sound like your pompous lawyer, but the securities laws are muddy waters. You really should check with me before doing anything like this."

"Don't worry, Horace, we won't take a farthing until you give us the go-ahead."

"What does the information sheet say?"

"Here's a copy. It describes the work we've done so far and our plans to take a machine to North Carolina later this year. At the bottom, there's a place for someone to tear off the paper and let us know if they would be interested in investing in our venture. That's when we'll give them whatever other information you think we should."

"Fellows, please, do not take any money from anyone until I can make sure we're doing this right. One mistake could doom our efforts. The law is that strict. I've been doing some research into what we need to do, and I'll have some answers for you very soon."

"Okay," Orville replied, "but remember that we need to start bringing in some money."

"Give me a couple of days. Meanwhile, please, no sales of any stock, and no more advertisements."

#### *Act I, Scene 4: Horace Explains the Options*

When Horace returned to the bicycle shop several days later, scale-model gliders of varying sizes and shapes were strewn along the floor. Wilbur was kneeling in front of an electric fan, manipulating a marionette-like paper glider. As the glider gyrated before the fan, Wilbur called out numbers to Orville who recorded them in a notebook.

"We're trying to figure out the drag problem, Horace," Orville called out. "Glider need lift, but once in the air, the drag brings them down. Maximum lift with minimum drag—that's the riddle. I think we're close, though."

After twenty minutes, Horace was able to command the attention of his two inventor-clients. He didn't mind the wait, because he was not looking forward to what he had to say.

"Boys," he started, "I have to tell you that these new securities laws are not helpful. They're supposed to protect the public against fraudulent schemes, but it looks to me like they mostly hurt young inventors like you."

"We're not doing anything fraudulent," responded Wilbur, "so we should have no worries about that."

"You'd think so," Horace replied, "but these registration provisions are so time consuming and costly that they make it near-impossible for young entrepreneurs like you to raise money. Here's what I've found. First, for federal law purposes, you have to file a registration statement unless you can qualify for an exemption.<sup>34</sup> Preparing a registration statement will probably take a couple of months,<sup>35</sup> then the SEC will have to review it. And meanwhile, you can't sell a single share of stock. You're stuck in a long timetable and running up expenses with no way to pay for them. Once you've got the SEC go-ahead, the questions become how much can you raise, and how quickly? Who knows? You're a new and untested company. What's more, registration entails potential liabilities that might not be imposed in unregistered offerings.<sup>36</sup> In a nutshell, registration involves huge problems in terms of time, costs, and potential liabilities, all the while not knowing whether an offering will even be successful."

"Anything that takes several months won't work," Orville noted. "We've got to have money in hand within a month to prepare for our North Carolina experiments."

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<sup>34</sup> Section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (1994), prohibits the offer or sale of a security through the means of interstate commerce "[u]nless a registration statement is in effect."

The Securities Act of 1933, ch. 38, 48 Stat. 74 (1933), has been codified, as amended, at 15 U.S.C. §§ 77a-77z, 77aa (1994). References to specific sections of the 1933 Act correspond to letters of the alphabet as follows: section 1 is 15 U.S.C. § 77a, section 2 is 15 U.S.C. § 77b, and so on. Several sections referred to in this Essay are not in the original Securities Act of 1933.

<sup>35</sup> A small business issuer, defined in Rule 405, 17 C.F.R. § 230.405 (1999), as a company with less than \$25 million in both annual revenues and public float, is eligible to use the Form SB-1 registration statement to register up to \$10 million of securities to be sold for cash. The basic registration form, Form S-1, must be used if no other form is permitted. 17 C.F.R. § 239.11 (1999). Form SB-1 disclosure requirements are very similar to those of Form S-1, the principal exception being that financial statements in the Form SB-1 do not have to conform to the stringent accounting standards applicable to the Form S-1. *Id.* § 239.9.

<sup>36</sup> Section 11 of the 1933 Act, 15 U.S.C. § 77k (1994), imposes disclosure liability for omissions or misstatements in registration statements. Issuers have no defense under this provision. Other potential defendants listed in the provision, including directors, chief officers, underwriters, and experts, may defend on the grounds of due diligence in reviewing and preparing the registration statement. Exempt offerings are not subject to section 11. Rule 10b-5 liability is premised upon scienter, or recklessness, a much higher standard of culpability than for section 11 liability. Although some exempt offerings might be subject to liability under section 12(a)(2), 15 U.S.C. § 77l(a)(2) (Supp. III 1997), that provision applies only to those who actually solicited the purchasers. *See Pinter v. Dahl*, 486 U.S. 622 (1988). One commentator has suggested that the impact of section 11 may cause issuers to forego registration in favor of nonregistered offerings, a result that may counteract the statute's purpose by reducing rather than enhancing the quality of investor protection. *See James D. Cox, The Fundamentals of an Electronic-Based Federal Securities Act*, 75 WASH. U. L.Q. 857, 878 (1997).

"That's why I've abandoned the registration idea. We need to fit the offering into a registration exemption. Some registration exemptions are in the statute,<sup>37</sup> and others have been created by the SEC."<sup>38</sup>

"Is there an exemption for a business as small as ours?" asked Orville.

"Well, you'd think so, but there's not. There is an exemption for offerings up to \$1 million in a twelve-month period.<sup>39</sup> You could raise \$1 million this year, \$1 million the next, and so on. But, because you boys need more than a million, that exemption won't work."

"Afraid so. In fact, we're beginning to think it might take a little more than that."

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<sup>37</sup> Statutory exemptions in the 1933 Act are as follows: section 3(a)(11) (the intrastate exemption); section 4(2) (the private offering exemption); and section 4(6) (the accredited investor exemption). The SEC has used its rulemaking authority to create administrative exemptions under both the intrastate, Rule 147, 17 C.F.R. § 230.147 (1999), and private offering, Rule 506, 17 C.F.R. § 230.506 (1999), exemptions. Rules 147 and 506 do not necessarily mirror their statutory counterparts. Compliance with either the statutory or administrative provisions suffices for exemption purposes.

<sup>38</sup> Section 3(b) of the 1933 Act, 15 U.S.C. § 77c(b) (1994), authorizes the SEC to grant exemptions of up to \$5 million where it finds that registration "is not necessary in the public interest and for the protection of investors." The principal exemptions created by the SEC under that authority are Regulation A, 17 C.F.R. §§ 230.251-.264 (1999), for offerings up to \$5 million, and Regulation D, 17 C.F.R. §§ 230.501-.508 (1999), containing the exemptions under Rule 504 (offerings up to \$1 million) and Rule 505 (offerings up to \$5 million). The SEC also has created Rule 1001, 17 C.F.R. § 230.1001 (1999), the so-called "California exemption," which exempts offerings up to \$5 million by California-based companies that comply with certain specific state law requirements of the California Corporation Code, in particular, purchaser suitability requirements. *See* CAL. CORP. CODE § 25102 (West Supp. 1999). The SEC is prepared to grant a similar exemption for offerings in other states that adopt similar standards, but to date no state has submitted a request. The National Securities Markets Improvement Act of 1996 added section 28 to the 1933 Act, 15 U.S.C. § 77z-3 (Supp. III 1997), giving broad, additional exemptive powers to the SEC. To date, the Commission has not issued any registration exemptions under those powers. It has used its authority to increase the allowable amount of securities that may be offered in Rule 701 offerings under employee compensation plans. Rule 701, 17 C.F.R. § 230.701 (1999).

<sup>39</sup> *See* Rule 504 of Regulation D, 17 C.F.R. § 230.504 (1999). Rule 504 is the most liberal of all exemptions. There are no specific disclosure requirements, there are no limitations on the number or qualifications of purchasers, there are no limitations on the manner of offering, and shares sold under Rule 504 are not regarded as restricted securities. However, most states do not exempt offerings that are as unregulated as Rule 504; thus, issuers cannot utilize Rule 504 in those states. On February 19, 1999, the Securities and Exchange Commission tightened Rule 504 by amending it to prohibit general solicitation and general advertising unless the offering is (a) registered under a state law requiring public filing and presale delivery of a disclosure document to investors or (b) exempt under a state exemption that permits solicitation and advertising as long as sales are made only to accredited investors. *See SEC Adopts Registration Reforms to Deter Fraud in Microcap Stocks*, 31 Sec. Reg. & L. Rep. (BNA) 237 (Feb. 19, 1999).

"There is the so-called private offering exemption.<sup>40</sup> It's in the statute and is intended for limited offerings that are not widely publicized or marketed. You can raise as much as you want with that exemption. The problem is that the Supreme Court has interpreted that exemption to apply only to investors able to fend for themselves,<sup>41</sup> whatever that means."

"What *does* it mean?" Wilbur asked.

"Well, it's not at all clear. Banks and major financial institutions fit because they have the economic wherewithal and ability to evaluate investments. But those institutions usually don't invest in small companies like yours. As for individuals, courts have held that the private offering exemption applies only to investors who have so-called sophistication, meaning experience and some financial know-how.<sup>42</sup> Not too many of our good citizens of Dayton would qualify."

"I don't understand," interrupted Wilbur. "If we tell everyone all about us, about the risks and problems, and we do it in writing up front,

<sup>40</sup> See section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1994) ("The provisions of section 77e of this title shall not apply to—(2) transactions by an issuer not involving any public offering."); Rule 506, 17 C.F.R. § 230.506 (1999) (created by the SEC as a "safe harbor" private offering exemption). Rule 506 is contained in Regulation D, 17 C.F.R. §§ 230.501-508 (1999).

<sup>41</sup> See *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125 (1953). From 1947 through 1951 the company sold approximately \$2 million in common stock to hundreds of employees through an employee stock purchase program. There appeared to be no limitation on which employees were eligible to purchase stock, although the company argued that the program was limited to key employees. The SEC sought to enjoin the sales on grounds that no registration exemption existed. The lower courts rejected the SEC argument, finding that the sales were within the private offering exemption because they were limited in scope, but the Supreme Court held otherwise, stating that the private offering exemption was not applicable where offerees needed "the protections afforded by registration." *Id.* at 127.

<sup>42</sup> See, e.g., *Spatz v. Borenstein*, 513 F. Supp. 571, 585 (N.D. Ill. 1981) ("[P]rivate offerings, necessarily made to sophisticated investors, permit alternative methods of full disclosure."); *SEC v. Murphy*, 626 F.2d 633, 637 (9th Cir. 1980) ("Intertie took no steps to assure that the offering and sale were directed only to a small number of sophisticated, informed investors . . ."). However, case law is not uniform regarding the sophistication requirement for section 4(2) offerings. See *Doran v. Petroleum Management Corp.*, 545 F.2d 893, 902 n.10 (5th Cir. 1977) ("We do not intimate that evidence of the offerees' sophistication is required in all cases to establish a private offering exemption under § 4(2)."). It may be possible under the contrasting position that the statutory exemption could be met by full disclosure to a person of ordinary intelligence and understanding. For contrasting views on whether sophistication is a required element of the statutory exemption, see 3A HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, *SECURITIES AND FEDERAL CORPORATE LAW* §§ 3.45, 3.47 (2d ed. 1999) (stating that sophistication is required); Carl Schneider, *The Statutory Law of Private Placement*, 14 REV. SEC. REG. 869, 876 (1981) (stating that the "better view" is that sophistication is not an independent requirement). For a general discussion of the sophistication issue, see C. Edward Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L.J. 1081. A circuit-by-circuit survey of the sophistication issue is set forth in STUART R. COHN, *SECURITIES COUNSELING FOR NEW AND DEVELOPING COMPANIES* § 6.06 (1993).



are you saying that an average person in Dayton who doesn't have investment experience can't buy our stock?"

"That's the way I read it," Horace responded. "It's not enough that you give full disclosure. The buyers must have this so-called sophistication. And it's not just financial know-how. It might even mean that they have to understand your particular offering and the risks involved.<sup>43</sup> Now, there is a way around this, and that is to use the Rule 506 exemption, which also applies to private offerings. In a Rule 506 offering, people who lack the so-called sophistication can purchase their shares through someone called a purchaser representative.<sup>44</sup> That person is like an agent and is supposed to have the sophistication that the purchaser lacks."

"Excuse me," interrupted Orville. "Now you've mentioned a rule. Before you were talking about the statute. Are there two exemptions or one?"

"Two," Horace replied. "One is the exemption in the statute that simply says you have an exemption if the offering is not public. The other is the one that the SEC created in Rule 506, which is chock full of specific conditions."<sup>45</sup>

"Why would we want to use the rule if it's full of specific conditions?" Orville inquired.

"Because the rule offers a couple of advantages," responded Horace. "First, it only looks at purchasers, so you don't have to worry about the qualifications of persons who were made offers but didn't buy your shares. Second, the rule explicitly permits agents, so-called purchaser representatives, to act for unsophisticated buyers. It's not at all clear that courts will permit agents the statutory exemption."<sup>46</sup>

<sup>43</sup> See, e.g., *Andrews v. Blue*, 489 F.2d 367, 373 n.3 (10th Cir. 1973) (denying private offering exemption with respect to a clearly sophisticated real estate investor who was characterized by the court as "a babe in the woods when it came to stocks").

<sup>44</sup> Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b)(2)(ii) (1999), permits the use of a purchaser representative where the purchaser's knowledge and experience do not or doubtfully qualify under the sophistication requirement. Conditions for use of a purchaser representative are set forth in Rule 501(h), 17 C.F.R. § 230.501(h) (1999). Case law is sparse as to whether a purchaser representative is permissible under the statutory exemption, section 4(2). See, e.g., *Parker v. Broom*, 820 F.2d 966 (8th Cir. 1987) (upholding a private offering when one investor represented himself and business associates who also became investors).

<sup>45</sup> For a review of Rule 506 requirements in the context of a lawyer's letter to a client, see Marc H. Morgenstern, *Private Placement Guidelines—A Lawyer's Letter to a First-Time Issuer*, 48 BUS. LAW. 257 (1992).

<sup>46</sup> The use of purchaser representatives in a section 4(2) offering has not been judicially resolved. In *SEC v. Murphy*, 626 F.2d 633, 646 (9th Cir. 1980), the court gave mixed signals on this question. The fact that over 60% of the investors were represented by others evidenced a lack of investor sophistication, according to the court. However, the court also expressed concern that the representatives might not have been qualified, implying that the use of qualified representatives might be appropriate. See also *Parker v. Broom*, 820 F.2d 966 (8th Cir. 1987) (upholding private offering where one investor represented himself and business associates).

"Can our carpenter, Andy, buy shares?" Wilbur asked.

"Yes, if we use the Rule 506 exemption and Andy is represented by someone who qualifies as a purchaser. A friend, a lawyer, anyone will do. But under Rule 506 we can't have more than thirty-five nonaccredited investors like Andy."

"As I see it, then," Orville interjected, "we've got two choices on this private offering exemption. One is to use Rule 506, which will limit us to thirty-five unaccredited persons, or whatever ordinary persons are called, and we've got to make sure that those persons are represented by someone who is sophisticated if they're not. The other choice is to go with the exemption that's in the statute. What's it called, again?"

"Section 4(2)," Horace replied, "and you're right. If you go with the statutory exemption, there's no limit on the number of ordinary persons, as you call them, who could be purchasers, provided every one of them meets the sophistication requirement. On the other hand, section 4(2) is much more strict about making offers. Unlike Rule 506, which only concerns itself with who your purchasers are, section 4(2) requires that even persons who are offered shares must meet the disclosure and sophistication requirements."

"Can't we avoid that problem by making sure that we give offers only to people who meet the qualifications?" Orville asked.

"You could do that if it weren't for the fact that the notion of an offer is very broadly defined in the statute.<sup>47</sup> The statute doesn't use the term the same way we do in contract law. For example, you're offering to sell these bicycles because they are priced and ready to sell to whomever walks in the door. But suppose you don't have a price on one of them, or you just have a picture of a bicycle on your counter. Under contract law, we wouldn't say that you have offered that bicycle for sale. But under the securities law, the mere fact that you have tried to raise someone's interest in your stock is considered an offer, even if you're both a long way from any kind of commitment."<sup>48</sup>

"Just talking with people about the fact that we're selling stock can be an offer?" Orville asked incredulously.

"Orville, don't look at me that way. I didn't make the law," answered Horace.

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<sup>47</sup> Section 2(a)(3) of the 1933 Act, 15 U.S.C. § 77b(a)(3) (Supp. II 1996), defines an offer to sell to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."

<sup>48</sup> See, e.g., SEC v. Thomas D. Kienlen Corp., 755 F. Supp. 936 (D. Or. 1991) (issuer planning a registered offering held to have engaged in improper "offers" both through postcards advertising a meeting to learn about the proposed offering and brochures handed out at the meeting); SEC v. Arvida Corp., 169 F. Supp. 211 (S.D.N.Y. 1958) (answering questions from the press regarding proposed offering held to be an offer to sell).

"But there's a big difference between selling stock and asking for interested inquiries. How can there be any problem with asking people if they want more information?" Wilbur argued.

"That's what I would have thought," Horace answered, "until I started reading some of the caselaw and SEC no-action letters.<sup>49</sup> It seems that the ban on advertisements applies to offers, and offers are broadly defined to include any attempt to solicit interest in buying shares.<sup>50</sup> It doesn't matter if you tell them that they can't buy anything now and that they can't make any purchase until after they receive a disclosure document.<sup>51</sup> You can't have an advertisement because that would be an offer, and an offer cannot be made except to qualified investors.<sup>52</sup> No doubt some of the magazine readers would qualify under the private offering exemption to be investors, but there's also no doubt that some readers would not qualify. And the way I understand, if you've got one unqualified offeree, that's the end of your exemption."

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<sup>49</sup> A no-action letter is an SEC staff response to a request by a putative seller or buyer of securities that asks the staff to agree that, if the transaction is effected in the proposed manner, the SEC would take "no action" (hence the name for the process) under the securities laws. Such letters and the SEC responses are published and provide an excellent source of guidance regarding the SEC's position on various matters, although the staff responses are not technically formal Commission positions.

<sup>50</sup> In *Damson Oil Corp.*, SEC No-Action Letter, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,916, at 84,357 (July 5, 1974), an advertisement making no reference to a specific offering but asking for reader response from those who want "[t]o find out more" was regarded by the SEC as an improper first step in the offering process. In *SEC v. Freeman*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,361, at 93,243 (Mar. 3, 1978), an advertisement in a local newspaper that "equity positions" were available precluded the issuer's claimed section 4(2) exemption. The court stated, "This apparent pattern of soliciting offerees from among the public at large casts grave doubt on the claim that all offerees were qualified, even if the advertising of 'equity positions' is not itself considered to be an offer."

<sup>51</sup> See, e.g., Gerald F. Gerstenfeld, SEC No-Action Letter (Dec. 20, 1985), available in LEXIS, Fedsec Library, Noact File (advertisement by syndicator of limited partnerships that did not refer to any specific investment but asked readers to call or write for more information was regarded by the SEC as an offer of securities even if the syndicator had no current offerings and was only compiling a list of potential investors for future offerings).

<sup>52</sup> SEC pronouncements on the private offering exemption have consistently emphasized the limited manner of offering as a primary component of the exemption. In SEC Release No. 33-285, 1 Fed. Sec. L. Rep. (CCH) ¶ 2740, at 2911 (Jan. 24, 1935), the SEC General Counsel wrote:

I have very serious doubts as to whether in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the security in question.

"Just a second," Wilbur interrupted, "maybe I don't understand something. It sounds like you're saying that if we make an offer to a friend to buy our shares, and he doesn't meet the so-called sophistication requirement, we lose the statutory exemption even if he doesn't buy a single share."

"You understand it all too well," Horace replied.

"But why should anyone worry about offers to people who don't invest?" continued Wilbur.

"I wish I could give you a good reason, but I'm as stumped to defend that policy as you are. A big part of the problem is the way the statute is written. It talks about offers, not just sales. So we can't blame the SEC. In fact, the SEC took a fairly bold step in Rule 506 by limiting the inquiry to purchasers. But as to section 4(2), offeree qualifications are still a problem."

"I feel the same as Wilbur," asserted Orville. "If we sell shares only to persons who are qualified, who cares if offers might have been made to nonqualified persons?"

"I agree, no one should care. No one has been harmed in any way. But that's the way the law has been written and that's the way the SEC and courts have been interpreting it. Offers to unqualified people ruin the statutory exemption. If the exemption is lost, you could be sued."

"But if the only people who buy shares are qualified," Wilbur asked, "who could sue us for making offers to unqualified persons?"

"Ay, there's the rub, if I get my Shakespeare right," Horace responded. "If you don't follow every detail of the exemption, the exemption is lost. If you're still within the one-year statute of limitations,<sup>53</sup> any purchaser, or all of them together, can sue to get their money back. It's automatic, there is no defense to a registration violation. I read one case where an admittedly sophisticated investor got his money back because the company couldn't prove that *other* offerees who *weren't* purchasers were qualified.<sup>54</sup> And if you and Orville helped sell the shares, they can recover their money from you, even though you didn't take a nickel for yourself."<sup>55</sup>

"Suppose we concentrate on Rule 506," Orville suggested. "Maybe we can find the right combination of qualified investors plus thirty-five others. We can get an advertisement into *Aeronautical Annual*, which is coming out in a few weeks. Their readers know about flying machines, the risks and problems, and I would imagine that some of them could

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<sup>53</sup> See The Securities Act of 1933 §13, 15 U.S.C. § 77m (1994). An action under section 12(1), which is the registration liability provision, must be brought within one year from date of violation.

<sup>54</sup> See *Doran v. Petroleum Management Corp.*, 545 F.2d 893 (5th Cir. 1977).

<sup>55</sup> See *Pinter v. Dahl*, 486 U.S. 622 (1988) (holding that liability under section 12(1) extends to all persons who solicit others on issuer's behalf, whether motivated either by self-interest or a desire to benefit the issuer).

meet the sophistication standards. We'll ask anyone who is interested to write to us for a brochure."

"Not a brochure. It's called a private placement memorandum, and it will be pretty lengthy and detailed.<sup>56</sup> But I'm afraid the magazine ad won't work. That would be general advertising, just what we can't do."

The brothers could only shake their heads at what they were hearing. An advertisement that only asks people to let the company know if they are interested in receiving additional information violates the law. It doesn't matter what the advertisement says, it doesn't matter who reads it, and it doesn't matter that only sophisticated people end up buying the stock. In fact, Orville realized, the brochures they've been giving to customers and the advertisement in the Dayton newspaper already must have violated the private offering exemption.

"I've got an idea," Wilbur piped up. "Octave Chanute can give us \$300,000. He thinks that he could raise another \$500,000 from friends in New York. We'll get that money in, then we'll raise the rest under the \$1 million exemption you mentioned."

"I like your ingenuity, Wilbur, but unfortunately the SEC has already thought of that. They've developed what they call the integration doctrine.<sup>57</sup> Again, it's something that's not altogether clear, but it seems that if you have more than one type of offering within the same time period, all the offerings will be treated as if they are part of a single offering. If two or more offerings are integrated, you've got to find a single exemption that fits all the offers and sales in that combined offering. Sales to Chanute and others would probably be integrated with your offers to eve-

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<sup>56</sup> Rule 506 offerings must meet the information requirements set forth in Rule 502(b)(2), 17 C.F.R. § 230.502(b)(2) (1999). There is no specific provision regarding disclosure requirements in a section 4(2) offering. Courts have generally required that offerees receive information consistent with what would be in a registration statement. *See, e.g.,* SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953) ("The employees here were not shown to have access to the kind of information which registration would disclose."); SEC v. Universal Major Indus., 546 F.2d 1044, 1047 (2d Cir. 1976) ("The focus of inquiry . . . is . . . whether they have the information which a registration would disclose, or have access to it.").

<sup>57</sup> One of the earliest SEC statements on the integration doctrine was issued in connection with the intrastate offering exemption. Exemption for Local Offerings from Registration, SEC Release No. 33-4434, 1 Fed. Sec. L. Rep. (CCH) ¶ 2270, at 2607 (Dec. 6, 1961). The SEC listed the following factors, any one of which may cause two or more offerings to be deemed integrated:

(1) Are the offerings part of a single plan of financing; (2) do the offerings involve issuance of the same class of security; (3) are the offerings made at or about the same time; (4) is the same type of consideration to be received, and (5) are the offerings made for the same general purpose.

*Id.*

This five-factor test is repeated in near-identical form in Rule 147, applicable to intrastate offerings, and Rule 502(a) of Regulation D, applicable to exemptions under Rules 504, 505, and 506. For a thorough history of the integration doctrine, see Darryl Deaktor, *Integration of Securities Offerings*, 31 U. FLA. L. REV. 465 (1979).

ryone else, as they would be close in time and purpose. That means that Chanute's purchases have to come under the same exemption as the sales to everyone else. So if he and his friends come up with, let's say, \$800,000, you could only raise another \$200,000 under Rule 504. And if we try to use the intrastate exemption for our sales in Ohio, then you can't get any money from Chanute or his friends. The integration doctrine will combine the Ohio offering with the sales to Chanute and his friends in Illinois and New York. That would kill the intrastate exemption. Even one offer, or one sale, to an out-of-state person destroys that exemption."<sup>58</sup>

"Wait a minute," Orville interrupted, "suppose Octave and his friends are qualified under the private offering exemption. We sell shares to them. A short time later we sell shares under a totally different exemption to totally different people. What would be wrong with that? Every sale would be proper under its own exemption. I can't see anyone complaining about that."

"No one should complain," replied Horace, "because every person has received exactly the protection accorded by the particular exemption used. But we're discussing rules that seem to make no economic sense. The integration doctrine really hurts small companies like yours that need to raise money often and quickly to develop their product and to stay in business. The SEC has ameliorated the problem a little bit by saying that there is no integration between some offerings if they are more than six months apart,<sup>59</sup> but six months can be a long time for a company to wait for more money."

"Suppose we ask Chanute and his friends for a loan, and then sell \$1 million in stock to others. Could we avoid integration?" asked Orville.

"We would stand a better chance because we're selling different securities to different people, but I wouldn't be at all confident about that," responded Horace. "Integration looks at a number of factors, and one of them is whether the sales are part of a single plan of financing. Debt is a security, just like equity. The SEC would probably look at the sales to Chanute and his friends as part of the same financing plan as sales to others. I tell you, fellows, I hate to be sounding so negative every time you come up with an idea, but there's not much we can do with all these rules."

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<sup>58</sup> See *SEC v. Galaxy Foods, Inc.*, 417 F. Supp. 1225 (E.D.N.Y. 1976) (holding that section 3(a)(11) exemption was lost when sale was made to one out-of-state resident); *SEC v. Hillsborough Inv. Corp.*, 173 F. Supp. 86, 88 (D.N.H. 1958), *aff'd*, 276 F.2d 665 (1st Cir. 1960) ("No reason has been suggested why the broad language of section 3(a)(11) should exempt issues, where some allegedly sporadic and unintentional sales have been made to non-residents . . .").

<sup>59</sup> Rule 147 and the exemptions under Regulation D contain six-month safe harbors. Offers or sales of securities made more than six months before or after a Rule 147, Rule 504, Rule 505, or Rule 506 offering are not integrated with the administrative exemption. There is no safe-harbor provision regarding integration of statutory exemptions under section 3(a)(11) or section 4(2).

"It looks like we're down to Chanute and his friends," Wilbur interjected.

"Not quite," Horace replied. "We haven't discussed either Regulation A<sup>60</sup> or Rule 505.<sup>61</sup> Under both exemptions you can raise \$5 million. The problem with Regulation A is that we've got to go through SEC review, and we have no control over when the SEC will tell us we can go forward. With Rule 505, you can't have more than thirty-five investors who are not accredited investors."

"Are accredited investors the same as sophisticated investors?" Wilbur asked.

"Sometimes yes, sometimes no, which itself is a little strange. Accredited investors are defined by who they are or how much money they make or are worth.<sup>62</sup> Many accredited investors might be very unsophisticated, especially when it comes to buying stocks. Considering that, it seems strange to me that you don't have to give them a disclosure document.<sup>63</sup> Anyway, under Rule 505 you can sell to an unlimited number of accredited investors, plus no more than thirty-five nonaccredited investors."

"Where do we find accredited investors?" Orville asked.

"I suppose the same place you'll find sophisticated ones. And that's the problem. Once again, we've got an advertising and solicitation problem. If we go looking for accredited investors, we can't do so by general means. We can only approach people with whom we've got some prior relationship."<sup>64</sup>

<sup>60</sup> Rules 251-263, 17 C.F.R. §§ 230.251-263 (1999).

<sup>61</sup> Rule 505, 17 C.F.R. § 230.505 (1999). Rule 505 is part of Regulation D and is subject to Rules 501-508 of that regulation.

<sup>62</sup> In general, accredited investors are defined in Rule 501(a), 17 C.F.R. § 230.501(a) (1999), as:

- (1) certain banks and other institutional investors;
- (2) regulated private business development companies;
- (3) organizations with assets in excess of \$5 million;
- (4) directors, executive officers, or partners of issuer;
- (5) a person whose net worth (along with spouse) exceeds \$1 million;
- (6) a person whose annual income exceeds \$200,000, or whose joint income with spouse exceeds \$300,000; and
- (7) trusts having in excess of \$5 million in assets.

<sup>63</sup> See Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1) (1999) ("The issuer is not required to furnish the specified information . . . to any accredited investor."). See also Donald C. Langevoort, *Angels on the Internet: The Elusive Promise of "Technological Disintermediation" for Unregistered Offerings of Securities*, 2 J. SMALL & EMERGING BUS. L. 1, 22-23 (1998) (absent empirical data regarding the quality of investment decisions by accredited investors, "the emphasis on accredited investor status may be more an accommodation to the capital raising desires of the small business community than as a sound exercise in investor protection.").

<sup>64</sup> See Patrick Daugherty, *Rethinking the Ban on General Solicitation*, 38 EMORY L.J. 67, 107 (1989) (there has never been a favorable staff response on a general solicitation question in the absence of a prior relationship with offerees); David B. H. Martin, Jr. & L. Keith Parsons, *The Preexisting Relationship Doctrine Under Regulation D: A Rule Without Reason?*, 45 WASH. & LEE L. REV. 1031, 1044 (1988) ("The staff's

"What about our customers?" Orville asked.

"I would have thought that would be okay, but that relationship might not be enough," Horace replied. "I read one no-action letter in which the SEC staff turned down a proposed letter to selected customers.<sup>65</sup> It seems that the relationship has got to be such that you know that the person solicited has the experience to evaluate the merits of the offering and the financial ability to bear its risks."<sup>66</sup>

"We don't know all that for very many of our customers," noted Wilbur. "What do other companies do to attract investors?"

"That's a good question," Horace replied. "In fact, I asked the same thing of Lou Poston. He tells me that some companies ask his firm to use their customer base for solicitation purposes. Apparently, that can be done if the broker's customers are already known to the broker to be accredited investors or qualified to purchase in a private offering.<sup>67</sup> I asked him about us, and he told us that our offering is too low to interest his firm—not enough commissions for the liability risks. I'm also told that there are matching services that create two lists: one of prequalified potential investors and the other of companies engaged in unregistered offerings.<sup>68</sup> The matching services provide the investors with brief descriptions of the companies. If the investors are interested in further

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interpretive letters . . . indicate that the staff believes a preexisting relationship between the issuer or its agents and offerees to be an almost absolute prerequisite to avoiding general solicitation in a regulation D offering.").

<sup>65</sup> The Tog Shop, Inc., SEC No-Action Letter, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,192, at 88,139 (May 4, 1977).

<sup>66</sup> Mineral Lands Research & Marketing Corp., SEC No-Action Letter (Dec. 4, 1985), *available in* LEXIS, Fedsec Library, Noact File.

<sup>67</sup> See Arthur M. Borden, Esq., SEC No-Action Letter (Oct. 6, 1978), *available in* LEXIS, Fedsec Library, Noact File. Prequalification is established through questionnaires sent by brokerage firms to existing customers and others who might be qualified investors. The SEC allows the development of a pool of potential offerees through this method, provided that the questionnaires are not sent out in connection with any pending offering. See H.B. Shaine & Co., SEC No-Action Letter (Mar. 31, 1987), *available in* LEXIS, Fedsec Library, Noact File.

<sup>68</sup> In recent years the SEC has permitted the development of computer-based matching services that seek to put together start-up and young companies with prequalified investors who satisfy the accredited investor standards of Regulation D. Under such services, both companies and potential investors pay annual fees to the program manager, whose services are limited to providing basic offering information to potential investors. Any followups are made solely by the interested investors. The program coordinators refrain from any recommendations or advice regarding the companies or investments. See, e.g., Texas Capital Network, Inc., SEC No-Action Letter, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,857, at 78,542 (Feb. 23, 1994); Technology Capital Network, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,273, at 77,002 (June 5, 1992). Initially, the SEC's concerns were such that it limited such services to nonprofit organizations, such as universities. The Commission now also allows for-profit firms to offer such services. IPONET, SEC No-Action Letter, [1996-1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,252, at 77,270 (July 26, 1996) [*hereinafter* IPONET, SEC No-Action Letter]. See Langevoort, *supra* note 63, for a review of the development of matching



information, they request it from the service or from the company.<sup>69</sup> We could look into submitting your offering to a matching service, but that could be a slow and unrewarding process. The matching service cannot make any recommendations, and it can only provide a very brief description of the company. We'll be at the mercy of unknown investors who will probably see your venture as fairly high risk.<sup>70</sup> Furthermore, we will have no control over any aspects of timing. We need to approach people quickly and directly. And that's what we can't do."

"Even if we could talk to a lot of people," Orville said, "we'd be limited to only thirty-five investors who are not accredited. That's a very low number. Why thirty-five? Why not fifty, or a hundred?"

"Thirty-five is just a number that the SEC grabbed onto and has stayed with. From a public protection standpoint, there's not much reason to keep the number so low.<sup>71</sup> But there it is, and we can't go over it by even one," replied Horace.<sup>72</sup>

Silence ensued for a short while before Orville spoke. "Horace, we've got to raise money and we've got to do it soon. We've probably already violated some rules with the brochures we've been giving out, and it's kind of you not to berate us for that. That's water under the bridge. Maybe we can convince Octave and his friends to fund us for as close to \$1.5 million as they can get. We can probably get a few of our friends at the Cash<sup>73</sup> to put in some money. If we come up short, we might have to cut some corners. Right now we just need to go forward. If the SEC tells

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services and the legal and investment questions raised by such nontraditional processes.

<sup>69</sup> See, e.g., IPONET, SEC No-Action Letter, *supra* note 68, at 77,270. Prequalified investors are given confidential passwords through which they may obtain Internet access to brief descriptions of private offerings by companies that have agreed to be listed in the service.

<sup>70</sup> See Langevoort, *supra* note 63, at 19 (suggesting that the risk and uncertainty inherent in start-up companies could result in sophisticated investors demanding the involvement of brokers and investment analysts to create the level of comfort necessary prior to making an investment decision, thus limiting the potential capital-raising impact of computer-based matching and solicitation programs).

<sup>71</sup> See C. Steven Bradford, *Transaction Exemptions in the Securities Act of 1933: An Economic Analysis*, 45 EMORY L.J. 591, 636-47 (1996) (arguing that economic analysis does not support a strict limit on the number of nonaccredited investors, nor does it support the distinctions in numbers of purchasers allowed in various exemptions, for instance, Rules 504 and 505 and Regulation A).

<sup>72</sup> Rule 508 of Regulation D, 17 C.F.R. § 230.508 (1999), creates a "substantial compliance" defense with regard to some technical violations of the Regulation's requirements. However, exceeding the maximum number of nonaccredited investors is deemed a "significant" deviation for which the provision does not apply. See Rule 508(a)(2). The number could be exceeded only if the issuer reasonably believed that there were no more than thirty-five nonaccredited investors.

<sup>73</sup> The National Cash Register Company, known locally as "the Cash," was founded in Dayton in 1890 and was the largest and most prosperous of all local businesses.

us that we've violated some rule, that's a risk we'll have to take. What's the chance of them learning about us?"

"I really can't say," Horace responded. "They obviously can't keep up with all the stock offerings made around the country. The advertisement and brochures would be a problem if they find out, but they might never hear about those.<sup>74</sup> The form that we'll file with the SEC doesn't ask whether there's been any general advertising or solicitation.<sup>75</sup> Let's do the best we can and keep the number as low as possible. And let's not sell any shares to anyone whom you've given a brochure to, or who is responding to your advertisement, even if they come asking for shares. We probably can't cure past problems,<sup>76</sup> but let's try to minimize them."

"Do you see any alternative, Wilbur?" Orville asked.

"I see it the way you do. Let's send a telegram to Octave and get started."<sup>77</sup>

<sup>74</sup> Horace may have wondered whether he had any obligations, ethical or otherwise, to advise the SEC or prospective investors of possible securities laws violations by his clients. The SEC has backed away from an earlier position, *see* SEC v. National Student Mktg. Corp., [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,360, at 91,913 (Feb. 3, 1972), and does not insist upon attorney disclosure to it of company violations. *In re* Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,145 (Feb. 28, 1981). The SEC's position is consistent with case law that elevates the principle of confidentiality above concerns for full disclosure. *See, e.g.,* Fortson v. Winstead, 961 F.2d 469, 475 (4th Cir. 1992) ("An omnipresent duty of disclosure . . . would destroy incentives for clients to be forthcoming with their attorneys . . .").

<sup>75</sup> Form D must be filed for offerings under Rules 504, 505, and 506 no later than fifteen days after the first sale of securities. Rule 503(a), 17 C.F.R. § 230.503(a) (1999). Failure to file Form D does not result in the loss of the exemption, but the SEC may use that violation as a basis to seek to enjoin future offerings. Rule 507, 17 C.F.R. § 230.507 (1999).

<sup>76</sup> There are no federal provisions for curing past violations. If the SEC learns of violations during an offering, it is likely to issue a stop or cease-and-desist order against any offering continuing for an indefinite period of time until the effect of the violation has been eliminated. Rescission offers might also be permitted under carefully controlled standards. *See* Alan Bromberg, *Curing Securities Violations: Rescission Offers and Other Techniques*, 1 J. CORP. L. 1 (1975). Most states provide for an offer of rescission as a method of curing state securities law violations, following the format in section 410(e) of the 1956 Uniform Securities Act. Problems faced in considering cures of past violations are discussed in STUART R. COHN, *SECURITIES COUNSELING FOR NEW AND DEVELOPING COMPANIES* ch. 17 (1999).

<sup>77</sup> Horace did not raise the possibility of seeking a venture capital investment. The advent of venture capital companies is a fairly recent phenomenon and did not exist in the early years of the securities laws. Even if such companies existed at the time, it is very unlikely that any of them would have been interested in the Wrights. Untested products or services are rarely regarded with favor by venture capitalists, who usually seek companies that have a good chance for a successful public offering within several years. Venture capital financing is extremely difficult to obtain for most new and developing companies. *See* 1 STEVEN C. ALBERTY, *ADVISING SMALL BUSINESSES* ch. 14 (1989).

*Act II, Scene 1: The Bicycle Shop, Winter 1901 and Spring 1902*

"It comes down to this, Wilbur, either Otto got it wrong or we did. His figures and our results just don't match."

"You're right, brother," responded Wilbur from the rear of their ever-more-crowded bicycle shop, "and I'm betting on us. Otto's tables look right on paper, but not in the field."

Otto was Otto Lilienthal, the German scientist whose prestige brought respectability to the heavier-than-air flying machine development.<sup>78</sup> Lilienthal was the first European scientist to take the possibility of powered flight seriously enough to develop laboratory data. Lilienthal's table of lifts provided by curved wings under varying wind conditions was the foundation for all flight experiments by the Wrights and their American and European counterparts. Unfortunately, Lilienthal was killed in a glider experiment in 1896. Subsequent to his death, no one devised a set of calculations confirming or challenging his venerable table.

The Wrights' 1900 and 1901 glider flights, based entirely on Lilienthal's figures, were not wholly successful. Occasionally the two-winged glider lifted effortlessly off the ground and rose quickly in the North Carolina shore breezes. But neither Orville nor Wilbur, who took turns piloting the glider from a prone position on the lower wing, could maintain the glider's lift when wind direction or speed changed. Even in a constant wind, there was more drag than Lilienthal's table indicated.

In 1900, the brothers were prepared to blame their own design and inexperience. The 1900 glider was designed to be eighteen feet wide, but the longest spars they could obtain from their supplier in Norfolk, Virginia, were only sixteen feet long. The two-foot difference concerned them. But the 1901 glider met their exact specifications, and again the experiments were marked more by failure than success. The brothers realized that they could go no further in their efforts without discovering the fault, either in their design or Lilienthal's table.

Winter 1901 and early Spring 1902 were devoted to lift calculations. The brothers constructed a small wind tunnel powered by a fan and homemade motor. Each evening, when the day's work of bicycle sales and repairs was finished, the wind tunnel was placed on the repair table along with dozens of small paper crafts of varying wing shapes and sizes. After the brothers determined the ratios of their experimental winds and weights to actual conditions, they began recording results. The results were analyzed and compared to Lilienthal's table, and any inconsistencies were confirmed. By Spring 1902, the brothers were convinced that their figures were correct, although many differed substantially from Lilienthal's. The wind tunnel experiments also gave them additional knowledge of wing design and manipulation.

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<sup>78</sup> See *supra* note 17.

Funding had not been a problem for the 1901 glider experiments. Profits from the bicycle shop and a small loan from the Dayton First National Bank were sufficient to support the 1901 flight experiments. As Summer 1902 approached, the brothers again faced the prospect of raising money for construction of their most ambitious gliders to date. Other costs involved travel, hiring of assistants, purchase of recording instruments, and the construction of hangars and a repair shop in North Carolina. Once again they needed their attorney's help.

*Act II, Scene 2: Planning Another Round of Financing, March 1902*

When the brothers met with Horace Alexander in early March 1902, they were confident that their revised calculations would lead to sustained and controlled flight. They were, they believed, only one year away from a motor-powered flight. But first their revised calculations and designs needed testing in actual flight conditions.

"How much do you need this time around?" inquired Horace.

"We figure about \$800,000." Orville laid a sheet in front of Horace detailing expenses.

"That should be good news," Wilbur added. "We remember you telling us that anything up to \$1 million had no problem."

"Well, yes and no," Horace replied. "Federal law gives us no problem. We can raise up to \$1 million under Rule 504 with no limitations on number of purchasers and no costly disclosure obligations.<sup>79</sup> That's the good news."

The brothers looked at each other. What shoe was going to drop now? They had heard enough bad news from the securities laws.

"Trouble is, most states, including Ohio, won't let us do a Rule 504 offering without being registered at the state level.<sup>80</sup> That means a full-blown registration statement, merit review, time, delay, and costs. In fact, the SEC recently amended Rule 504 to reinstate the old prohibition against general solicitation and advertising unless the offering is state registered or sold under a state exemption that permits solicitation where sales are made only to accredited investors."<sup>81</sup>

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<sup>79</sup> Rule 502(b)(1), 17 C.F.R. § 230.502(b)(1) (1999); Rule 504, 17 C.F.R. § 230.504 (1999).

<sup>80</sup> The Uniform Limited Offering Exemption (ULOE), the principal registration exemption in a majority of the states (including Ohio), conflicts with Rule 504 in several important respects. ULOE does not permit general advertising or solicitation, imposes a cap of thirty-five nonaccredited investors, and imposes a suitability requirement for sales to nonaccredited investors. A few states have linked their exemptions to federal exemptions, including Rule 504, *see, e.g.*, N.J. STAT. ANN. § 49:3-60(f) (West Supp. 1999), but these states are a distinct minority.

<sup>81</sup> The SEC announced the amendment to Rule 504 on February 19, 1999. *Microcap Fraud: SEC Adopts Registration Reforms to Deter Fraud in Microcap Stocks*, 31 Sec. Reg. L. Rep. (BNA) 237 (Feb. 19, 1999). The reinstitution of a prohibition against general solicitation and advertising, which had been eliminated from Rule 504 in 1992, was motivated by SEC staff concern that Rule 504 was being abused, especially

"Why can't the federal government make its own rules and keep the states out of it?" Orville cut in. "Who's in charge? I thought I remember learning something about federal law being the supreme law of the land."

"You did learn something about that, Orville, but that doesn't always apply. Congress could have preempted state law, but it chose not to. Quite the contrary, state law was specifically preserved in the federal statute.<sup>82</sup> Congress recently made some exceptions by preempting state registration for some types of offerings. Unfortunately, those exceptions don't give too much help to you or other small businesses.<sup>83</sup> So what we have is two governments both regulating the same activity."

"What are states afraid of?" Orville asked.

"Well, they are basically afraid of unscrupulous promoters selling junk stock. Remember, most states require some administrative review of registered offerings, and administrators can deny registration to offerings that do not meet their merit standards. But those standards only apply to registered offerings. Administrators are not comfortable leaving the peo-

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in the few states that did not require registration of offerings made pursuant to Rule 504. In New York, for example, a Rule 504 offering could be made by filing a State Notice on Form M-11. In a scheme that the SEC staff called "pump and dump," securities were sold to persons who immediately placed the shares for resale with broker-dealers. The broker-dealers engaged in cold-calling campaigns to resell the securities, generating investor interest that caused the share price to rise. When the initial block of shares was resold, the firms stopped their selling efforts. Without the artificial stimulus, the share price dropped, causing substantial losses to the new set of shareholders. The only parties making a profit were the initial purchasers and the broker-dealer firms. The new amendments to Rule 504 prohibit general solicitation or advertising unless the offering is registered in a state that requires presale delivery of a disclosure document or the offering is made under an exemption for sales to accredited investors only. Rule 502(c), 17 C.F.R. § 230.502(c) (1999); Rule 504(b)(1), 17 C.F.R. § 230.504(b)(1) (1999). If sales are to be made in New York, which has neither a compatible issuer registration procedure nor an applicable accredited investor exemption, the Rule 504 offering must be registered in at least one other state that meets the Rule 504 conditions. Rule 504(b)(1)(ii), 17 C.F.R. § 230.504(b)(1)(ii) (1999). Otherwise, no general solicitation or advertising could take place in New York.

<sup>82</sup> 15 U.S.C. § 77r (1994) (preserving the right of states to regulate securities offerings).

<sup>83</sup> The National Securities Markets Improvement Act of 1996 (NSMIA), Pub. L. No. 104-290, 110 Stat. 3417, amended section 18 of the Securities Act of 1993 to exempt from state registration and review any offering of a "covered security." "Covered securities" are defined to include, inter alia, (1) securities issued pursuant to Rule 506 of Regulation D; (2) securities issued to "qualified purchasers," a term not yet defined by the SEC; and (3) securities listed or authorized to be listed on a national securities exchange or NASDAQ's National Market System. For new and smaller issuers, NSMIA's federal preemption is of little import. Nearly every state already had in place exemptions regarding limited offerings that were analogous to Rule 506. Nor would such companies likely qualify for listing their securities on an exchange or NASDAQ's National Market System. See Rutheford B. Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAW. 575, 581 (1998) ("Notwithstanding such rhetoric and the Act's apparently broad preemption of state laws, NSMIA itself has no significant effect on the capital formation rules that govern small issuers.").

ple of their state open to fraudulent securities schemes, so they prefer very narrow registration exemptions. I can understand the concern, but I think the scales have tipped too far, and many young companies have great difficulty finding workable state exemptions."

"I can understand that," Orville replied, "but I can't see anyone complaining about us. Maybe we should register the offering in Ohio and sell as much as we can here."

"If you want to stay in Ohio," Horace responded, "and solicit all your friends and others around here, we'll have to go through a state registration. Given the so-so results from your glider flights so far, I don't know whether this offering would pass merit review muster. I would be surprised if those Columbus bureaucrats would share your optimism about your flying machine. In any event, the process will take months. And if they don't approve the offering, we will have wasted a lot of time without raising a wooden nickel. I doubt you want to take that chance."

"We can't afford to take that much time without the assurance of an offering at the end," Orville replied. "So what do we do?"

"Maybe we can combine federal private offering and state limited offering exemptions, which is basically what we've been doing so far with Chanute and others," Horace replied.

"I'm afraid Octave has reached the end of his funding. Last year's failures didn't sit well with him, nor has our criticism of his idol's famed lift table," Wilbur stated.

"Let's look at it differently," Horace added. "Suppose we tried to raise \$800,000 by going to a number of states, say ten to fifteen. Each state has an exemption for companies where the number of offerees or purchasers is low. If we're careful, and keep the numbers as low as possible, we might be able to avoid the general solicitation problems in Rule 504 and the state exemptions. Do you fellows know people around the country who could help us make contacts with prospective investors?"

Wilbur brightened at the suggestion. "We know a fair number of people through the Aeronautical Society meetings. We'll be giving a talk at the Society meeting in Chicago next month. We could easily say something about our need to raise some money."

"You could say it," Horace piped in, "but it would probably violate the solicitation provisions. Anything you say to a general or mass meeting about raising money will be construed as a general solicitation, and there goes Rule 504 and the state exemptions.<sup>84</sup> Some states may be more lenient than others about what constitutes general solicitation,<sup>85</sup> but we've

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<sup>84</sup> ULOE, based upon Regulation D's Rule 505, incorporates the Regulation's prohibition against general advertising and general solicitation. Most other state limited offering exemptions also prohibit advertising or solicitation.

<sup>85</sup> Curiously, Ohio is one of the few states that modifies the advertising limitation by statute. See OHIO REV. CODE ANN. § 1707.03(O)(1)(c) (West Supp. 1999) ("No advertisement . . . is used in connection with the sale, but the use of an offering circular or other communication delivered by the issuer to selected individuals does

also got to satisfy the SEC, which is especially touchy about what constitutes solicitation.<sup>86</sup> On the other hand, if you don't say anything in your speech but talk individually to whomever you see at the meeting, and get those people to agree to set up some individual meetings in their home states with you and their friends who they know have some savvy and can afford to make an investment, we might be able to manage. It's close to the line, but it's the best we can do without registration.<sup>87</sup> Meanwhile, I'll start drafting a disclosure document we can give to prospective investors."

*Act II, Scene 3: Kill Devil Hill, North Carolina, October 1902*

Time after time the double-winged glider rose into the winds, flew several hundred feet, and was brought to a controlled landing by Orville or Wilbur. Improvements over the prior year's model gave them control of both lift and drag, maneuverability to both left and right, and responsiveness to changing wind conditions. A major addition was the tail, added in order to counterbalance resistance differences of the two wing-tips. The glider flew so well that it was clear that the next step was motor-powered flight. They already had a name for the future air machine—the Wright Flyer.

Horace had arrived in North Carolina to witness the experiments first hand. He wanted to be knowledgeable, as he would soon be drafting the registration statement to finance the culminating flight experiments. The patchwork fundraising efforts in prior years would not be sufficient this time. The brothers no longer had the time to duplicate their enormous personal efforts in prior months, traveling to twelve states to raise money from aeroplane enthusiasts and their friends. Production and experiment costs for the motored flights were estimated at \$3 million. Horace had considered a Regulation A offering, but he was quickly dissuaded when he realized that Regulation A offerings would nevertheless

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not destroy this exemption."). Whether a speech delivered at a national conference qualifies for the exemption is uncertain. The modification applies only to Ohio's exemption where the number of purchasers does not exceed ten in a twelve-month period. Ohio's ULOE exemption does not contain an analogous modification provision. See OHIO REV. CODE ANN. § 1707.03(W).

<sup>86</sup> See *supra* text accompanying notes 47-52 and 64-68.

<sup>87</sup> Horace's advice, albeit practical under the circumstances, raises ethical issues. He is counseling a course of action that could be in violation of both federal and state securities laws. Horace might convince himself that his clients can stay on the proper side of the law, but he knows, or should know, that there is a substantial risk that the marketing of the securities will run afoul of solicitation prohibitions. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1995) (forbidding lawyers from assisting a client in conduct the lawyer knows is criminal or fraudulent). Unfortunately, the straitjacket-like rules regarding exemptions can leave small companies with little practical choice but to raise much-needed capital and keep their proverbial fingers crossed that no legal problems arise. Lawyers advising such clients are inevitably placed in ethically compromising circumstances.

have to be registered in most states.<sup>88</sup> Moreover, Lou Poston at Daniel & Sons had told him that his brokerage firm would not be interested in participating in a rather small offering that was not federally registered.<sup>89</sup>

Horace's principal fear was that he would have trouble convincing state administrators, especially in Ohio, that the offering should pass state merit review. Horace kept that concern to himself. Perhaps the Columbus bureaucrats would be reasonable after all.

*Act III, Scene 1: Prospectus Preparations, May 1903*

Much of the prospectus for the Wright Flying Machine Company remained unwritten as Spring 1903 rolled around. The primary disclosure uncertainties involved the engine manufacture and the propeller design. The Wrights prepared specifications calling for a gasoline engine weighing no more than 180 pounds and capable of developing eight to nine horsepower without vibration. To the brothers' dismay, not a single engine manufacturer offered to build to those specifications. The rejections caused considerable delay. Eventually, the brothers had no alternative but to build the engine themselves.

Months of testing and refitting resulted in an engine that appeared to meet their needs. The engine, however, was the least of their worries; an engine could be tested within the workshop. The propeller could not be tested, and no one had ever designed a propeller for an air machine. The brothers' theories regarding propeller size and shape would not be tested until the Wright Flyer was airborne. In fact, the brothers decided upon two propellers—one each on the left and right sides of the engine. The propellers would be driven by a single chain that looped in a figure eight between them, causing the propellers to spin in opposite directions. It was thought that opposite momentums would create a balance that would not be achieved by a single propeller.

When Horace entered the bicycle shop on a sunny May afternoon, he was greeted with the confident assertion by Wilbur that "we've done all that we can. There's nothing left to do but build and fly."

"Nothing, that is, except to raise the money," Horace responded.

"That's what we've left to you and Lou," replied Orville. "How's the prospectus coming along?"

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<sup>88</sup> Only a handful of states permit Regulation A offerings to be exempt from state registration. Ohio is not one of those states. See *infra* note 112 and accompanying text.

<sup>89</sup> Smaller offerings are of little interest to broker-dealer firms because they generate too little commissions relative to the underwriting risks. Regulation A's \$5 million limit is an impediment to using brokerage firms for such offerings. Moreover, underwriters prefer registered offerings by companies because of the higher due diligence that generally accompanies such offerings. The liability standards imposed upon company management for registered offerings, plus the level of review given by the SEC, offer a measure of confidence to underwriters that there are no lurking disclosure problems for which they too might be liable.



"Here's the final draft, boys. I want you to look it over carefully and give me your comments. You'll have to sign it as directors of the company,<sup>90</sup> and you'll be legally responsible for any mistakes.<sup>91</sup> As soon as I get it back from you, I'll file it in Washington, D.C., in Columbus, and in the other states we've discussed."

"How long before we start selling stock?" Orville inquired.

"Not long. The federal statute says that we can start twenty days after filing.<sup>92</sup> We should be okay if Daniel & Sons comes through as they think they can."

Within minutes after Horace left the shop, the brothers were poring over the draft prospectus, smudging its pages with oil and dirt stains. They were not too happy about the "Risk Factors" with which the prospectus began.<sup>93</sup> They were not sure that anyone would want to purchase their stock after reading that section. Both Horace and Lou Poston had advised the brothers not to get upset about those disclosures. According to Lou, a prospectus was not important in selling shares. Very few of his clients ever read them. The only thing that they wanted to know was their brokers' recommendations.<sup>94</sup>

The prospectus was returned to Horace with a few corrections, principally dealing with description of the aeroplane's design. The registration statement was at the local printing company within a week, and

<sup>90</sup> Registration statements must be signed by the issuer, the principal executive officer or officers, the principal financial officer, the comptroller or principal accounting officer, and the majority of the board of directors. *See* Securities Act of 1933 § 6(a), 15 U.S.C. § 77f(a) (1994).

<sup>91</sup> Section 11 of the 1933 Act, 15 U.S.C. § 77k (1994), imposes liability upon each registration statement signatory for any material misstatements or omissions, subject to certain due diligence defenses and reliance upon expertised portions.

<sup>92</sup> *See id.* § 77h(a) ("Except as hereinafter provided, the effective date of a registration statement shall be the twentieth day after the filing thereof or such earlier date as the Commission may determine . . ."). This provision caused some personal embarrassment in my first encounter with drafting a registration statement. On the day that I was assigned responsibility within the law firm, the client called wanting to know how long the SEC review process would take. After reading the statute, I advised that we should be through the SEC within twenty days. I was not aware of the delaying process then informally imposed and now codified in Rule 473, 17 C.F.R. § 230.473 (1999), by which the issuer waives the twenty-day period. The registration statement, in fact, took approximately eleven months to become effective. The delay was due to numerous technical and financial disclosure issues raised by the SEC through comment letters. (The issuer was engaged in an overseas business and had not made a profit for over five years.)

<sup>93</sup> Item 503(c), Regulation S-K, applicable to all Form S-1 filings, requires registrants to discuss "the most significant factors that make the offering speculative or risky." *See* 17 C.F.R. § 229.503(c) (1999). A similar requirement is imposed upon registrants who utilize the Form SB-1.

<sup>94</sup> Indeed, one of the principal ironies of the disclosure system is the acknowledged fact that very few investors (other than institutional investors) read the prospectus or understand what they have read. Issuers often believe that a prospectus is a selling instrument, while their attorneys are more likely to regard disclosure as part of the process of protecting clients against liability claims.

shortly thereafter the Wrights had the "red herring" prospectus in hand.<sup>95</sup> Horace filed the prospectus with the SEC and with the state securities divisions in Ohio and a dozen other states. The waiting period began.

*Act III, Scene 2: The State of Ohio Weighs In, July 1903*

"What does this letter mean? We can't sell shares in Ohio?" Wilbur queried his obviously disturbed lawyer.

Horace had dreaded this turn of events. Nearly two months had passed since filing the registration statement, and now the Ohio Division of Securities dealt the blow he had feared.

"I'm afraid it might be worse than that," he began. "Ohio is our home state. If Ohio won't let us sell your shares, it's likely that all the other states will follow suit."<sup>96</sup>

"This letter basically says that we've got a risky offer. Everyone knows that. Why not let the investors decide for themselves?" Orville asked.

"I couldn't agree with you more," responded Horace. "Unfortunately, these merit review laws are written very broadly, and state regulators consider themselves on the side of the angels by protecting us from our own folly."

The object of this unhappy discussion was lying on Horace's desk, complete with the seal of the State of Ohio. It read:

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<sup>95</sup> A registration statement consists of two parts. Part I is the portion that eventually is circulated among potential investors and is known as the prospectus. Part II contains information provided only to the SEC, for example, copies of material contracts, costs of the offering, and reports on recent sales of unregistered securities. A "red herring" is a draft prospectus after it has been filed with the SEC and it may be used for solicitation purposes. The term is derived from the red lettering across the cover page warning that the registration has not become effective and that the prospectus information "will be amended or completed." 17 C.F.R. § 229.501(b)(10) (1999).

<sup>96</sup> Until recent years, each state in which an offering was to be made conducted its own review of the registration statement under its own standards, each would respond separately to the registrant, and each might impose its own offering conditions, such as escrowing of funds. Some states were generally regarded as more difficult than others, but as a rule the issuer's home state was considered the most important state in which to receive favorable review. If the home state denied a registration statement, other states often followed suit. Recently, states have begun to form regional groups for the review of registration statements. In 1997, the North American Securities Administrators Association (NASAA) developed the most comprehensive coordinated review process, called "Coordinated Equity Review," for certain types of smaller offerings. Coordinated through the Arizona Securities Administrator, each offering has two "lead states" selected by the Coordinator. The lead states collect comments from other state administrators and present a unified response to the registrant. See *State Program to Simplify Stock Sales for Mid-Sized Firms Sees First Offering*, 29 Sec. Reg. & L. Rep. (BNA) 1150 (Aug. 15, 1997).

Dear Sir:

*After careful review of the registration statement filed with our office on June 2, 1903, by the Wright Flying Machine Company, we have concluded that the proposed offering of shares would be grossly unfair to the citizens of the State of Ohio. For that reason, we must deny the application.*

*We base our conclusion on the untested nature of the company's product. There is considerable doubt that a motor-powered air machine will succeed. Even if one or more test flights are successful, there is a complete lack of evidence that the company will profit from the venture. As the prospectus points out, there is no market for the sale of such air machines nor for their commercial use. Given the enormous and obvious risks of flying in an air machine, it is highly doubtful that registrant's invention will ever have any commercial value. The prospectus makes reference to the machine's possible use for military purposes, but you have presented no evidence of any government contractual arrangement or negotiations.*

*Our obligation to the citizens of Ohio is to assure that share offerings offer a respectable degree of possible profit when measured against the risk. We must therefore conclude that the proposed offering cannot go forward in this state.*

*Respectfully yours,*

*Derrick Cochrane*

*Inspector, Ohio Division of Securities*

"What now?" Wilbur asked glumly, as the enormity of this refusal sank in.

"We've got to fight this," Horace replied. "The three of us should meet with this Derrick Cochrane as soon as possible. Can you go with me to Columbus later this week if I can arrange an interview?"

The brothers knew that they had no choice. Silently, they both wondered why their own state was making it so difficult for them to succeed.

### *Act III, Scene 3: The Ohio Division of Securities, July 1903*

Derrick Cochrane graduated from Ohio State Law School in 1902. Not a top student in his class, he was thrilled to receive an offer from the Ohio Division of Securities. His job as Inspector was low-paying but offered the reward of public service. Derrick remembered well the advice the Division Administrator gave him on his first day at work—be fair, but when in doubt, err on the side of public protection. He had reviewed over twenty registration statements during the past year, and the Wright Flying Machine Company was his first denial. The denial had given him a strange sense of satisfaction, as it confirmed his commitment to the public interest. He was impressed by the Wright brothers' efforts. But, he told himself, respect for inventiveness and daring did not translate into a sound economic investment.

Following introductions, Horace went immediately to the point. "Can you tell us, sir, exactly what you see as the problem with this offering? We certainly know that we are in uncharted waters, but so was Thomas Edison."

"Mr. Alexander, please don't compare your clients to Mr. Edison. His invention had immediate and foreseeable economic consequences. What we have here is entirely speculative. Indeed, it is speculation piled upon speculation. Will your clients' machine get off the ground? History is not on their side. Your prospectus notes the failures of eminent scientists to devise an air machine that can carry a person. With all due respect, neither of your clients graduated from high school.<sup>97</sup> Will they succeed where trained scientists have failed? Apparently the Patent Office doesn't think so."<sup>98</sup>

Derrick paused, clearly pleased with his response thus far to his first confrontation with a rejected issuer and counsel. He continued, "Even if your clients are able to get a machine off the ground, will the success be worth anything? May I add, in answer to your question, that it is not *my* job to convince you of my conclusions. It is *your* obligation to prove the merits of this offering. I'm afraid that as much as I admire the ingenuity and bravery of your clients, I must conclude that this share offering is not a worthy economic investment. Perhaps you can convince administrators in other states, but not here."

"But you well know," Horace interrupted, "that without Ohio's approval we are not likely to be approved anywhere. This is so frustrating. My clients are on the verge of making history, yet we are stymied from raising the necessary funds."

"You're not stymied, as I see it," Derrick responded. "So far you've managed to raise close to \$2 million from wealthy backers in private transactions."

"True," Horace replied, "but our prior investors have nothing left to give us. Perhaps we could get small amounts from them, but we need \$3 million. If we could find that money privately, of course we would. But we don't have access to lots of well-to-do people. Without general solicitation, we don't know where to look. And without registration, we can't engage in widespread solicitation. That's our dilemma."

"I understand your dilemma, and I wish your clients well. But, the concern of this office is safeguarding the public from unreasonable risk. Your prospectus shows practically no hope of economic return. Even assuming they can fly, are these air machines going to be sold? Who is going to build them? And who will use them? How many people will be willing to risk their life for a few minutes in the sky? Where is the profit in

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<sup>97</sup> Orville dropped out of high school, having found it not worth his time. Wilbur did not complete his senior year due to his family's move from Richmond, Indiana to Dayton. Neither brother applied to any college or university.

<sup>98</sup> In 1903, the Wrights filed their first patent application. The application covered a glider incorporating all of their developments to date, including a wing-warping system and rudder. The U.S. Patent Office quickly rejected the application, stating that the device was clearly "inoperative" and "incapable of performing its intended function." CROUCH, *supra* note 1, at 246 (internal quotation marks omitted).

this product? There isn't any, as far as I can see. At least not for the foreseeable future. I'm afraid, Mr. Alexander, that under our standards I have no choice but to deny the application."

Orville could stay quiet no longer. "Sir, my brother and I don't know anything about the law. We're just two folks trying to raise money for an honest venture. Now, you talk about risks. Sure, we know those risks better than anyone else. But they are put down in black and white—pages of them. Mr. Alexander wrote so many of them that we began to wonder whose side he was on. But he told us how important disclosure was, so we understood. What I hear you saying now is that you, or the State of Ohio, don't trust the judgment of the people who read this thing. I don't mean to offend, but we've put so much effort into this project over the past four years, we're on the brink of success, and we just need the funds to finance this last act. It seems to me that our state government should be helping us, not standing in the way."

"Mr. Wright," Derrick answered, "as I see it, this office is helping you. Maybe you don't see it that way, but the most likely result we foresee is a slew of mighty unhappy investors. They'll be at your doorstep, asking where the money they gave you is, why you aren't paying any dividends, and why the shares aren't appreciating in value. And when you have to tell them that you don't have any dividends to pay, that you don't have any profitable prospects, and that their money has been spent and is gone, their next stop will be their lawyers' offices. As I see it, our job is to protect all the citizens of this state, both promoters and investors. And I think we do a pretty good job."

"Mr. Cochrane," Horace began, after a brief clearing of his throat, "I can't help but point out that last year that fellow in Akron took \$3 million from the trusting citizens of that community and disappeared before anyone realized that the certificates he was selling were entirely bogus. And I remember a similar incident a few years ago in Cleveland involving a so-called Ponzi scheme that again resulted in millions of lost dollars.<sup>99</sup>

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<sup>99</sup> A Ponzi scheme is one that involves using new investor money to pay older investors a promised interest or other economic return. Investors are not aware of this circular use of invested funds and are falsely led to believe that the economic return is being generated by company operations, which are usually minimal or nonexistent. The term "Ponzi scheme" is derived from the notorious activities of Charles Ponzi in Boston, beginning in December 1919. Ponzi offered investors a 50% return on short-term notes, claiming that his company would earn huge amounts through the international trading of postal coupons. Interest payments were made on a timely basis, causing others to believe in the merits of the company. In fact, no business operations were ever undertaken. Ponzi collected over \$14 million within eight months and made payments of approximately \$9 million to his investors. The scheme was finally exposed in August 1920 by a Boston newspaper. Ponzi was sentenced to prison, from which he was paroled after three years. Following a second conviction several years later for a real estate fraud, he was deported to Italy and was employed by Mussolini in the Ministry of Finance. See *In re Ponzi*, 268 F. 997 (D. Mass. 1920); see also *Merill v. Abbott*, 41 B.R. 985, 994 (D. Utah 1984); John Train, *Mr. Ponzi and His Scheme*, HARV. MAG., May-June 1984, at 12.

Please excuse me for saying so, but it seems to me that your office ought to be putting its energies and resources into discovering and stopping fraudulent schemes instead of preventing hard-working entrepreneurs from raising money for honest ventures."

"Mr. Alexander, our office cannot police the world. When promoters of fraud work outside the law, we often do not learn about that until it's too late."

"That is my point, sir," Horace replied. "Because fraudulent offerings never get filed, the registration process does not protect people against such nefarious schemes. You can't stop the fraud artists who simply ignore your office and the law. It is only the law-abiding entrepreneurs like my clients who make your filings, and then they are required to satisfy all kinds of technical requirements and merit review judgments. The majesty of the law is imposed on the wrong people. Something doesn't seem right with all this. I believe that your attention should be focused on prosecuting those who deliberately or wantonly take advantage of others. If you are dealing with honest, good faith promoters, why not just ask whether they have given full disclosure to potential investors? If they have, let the investors decide whether or not to buy their shares."

"I appreciate your eloquence, Mr. Alexander," answered Derrick Cochrane coolly, "but you are asking this office to rewrite the laws, and of course we cannot do that. Nor should we. Simply because fraudulent schemes occur outside our control does not justify our office permitting all offerings to be inflicted on the citizens of this state, however well-meaning the promoters may be."

Horace realized that there was no chance of moving Derrick Cochrane off his opinion. He seemed almost to enjoy this opportunity to slam the door on the Wrights' fledgling company. Horace asked as politely as possible if Mr. Cochrane's letter also represented the view of the Division Administrator.

"I can assure you, sir, that I have the Administrator's full support on this matter," Derrick stiffly replied. "Of course, you have the right to appeal, but I seriously doubt that you will find a court of law prepared to overturn our decision."<sup>100</sup>

The mood was somber in the train car back to Dayton. Wilbur and Orville pressed Horace for his ideas on the next course of action.

"My opinion," Horace replied, "is that we concentrate on New York. The offering has been cleared there."<sup>101</sup> Lou tells me that his office has

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<sup>100</sup> Denials by state administrators are rarely appealed. The breadth of authority granted to administrators supports wide discretion in their decision-making. Generally, companies seek to work out problems with states through such measures as agreeing to escrowing of funds and increased conditions on promoters' equity and control. If the state objection goes to the heart of the offering's viability, there is little that can be done to reduce that concern.

<sup>101</sup> New York, as well as the District of Columbia, generally does not require issuer registration but instead relies upon broker-dealer registration for any offering

good contacts in that state. Whether we can sell most of the \$3 million there is the big question. Whatever Lou's office can't sell, we can try to sell ourselves under state exemptions in Ohio and elsewhere."

"Let's get started and find out. Time is really short now," Orville interjected.

"I wish we could get started, but we're still waiting for SEC approval," Horace replied.<sup>102</sup>

"Why haven't we got federal approval yet?" Wilbur inquired. "You told us it would take only twenty days. It's been almost two months."

"I never should have said anything about twenty days," Horace admitted. "I read the statute too literally. I didn't realize the SEC has its ways around that one."<sup>103</sup> We're basically at their mercy when it comes to timing."

"So you're saying that we don't have any timetable?" asked Wilbur.

"I'll send a telegram to the SEC to see where things stand. We just answered that one letter we got from them three weeks ago."<sup>104</sup> It asked us everything from how you develop your engineering data to how a flying machine will ever make a profit. Plus all that supplemental information they asked for—all those experimental notations you fellows have been making. I hope they'll be satisfied and let us move ahead now. I'll send them a telegram to try to hurry things along."

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made within the state. New York requires issuer registration only for real estate syndication offerings (which are broadly defined) and intrastate offerings that utilize the federal intrastate offering exemption. N.Y. GEN. BUS. LAW §§ 352-e, 359-ff (McKinney 1996).

<sup>102</sup> Although it is common to speak of "SEC approval" in referring to the time at which the SEC staff declares the registration statement effective, the SEC does not approve (or disapprove) of any offering (as the cover page of every prospectus is required to state). The SEC staff's decision to permit a registration statement to become effective simply reflects the fact that the staff has no further comments or requests for information regarding the filing.

<sup>103</sup> See *supra* note 92.

<sup>104</sup> First-time issuers receive careful review of the draft registration statements by the SEC's Division of Corporate Finance. Following several weeks of review, the Commission staff generally sends a comment letter (in common parlance, sometimes referred to as a "deficiency letter") to the registrant advising it of the disclosure matters that, in the staff's opinion, should be amended, added, or deleted, and often asking for supplemental information from the registrant to support statements made in the registration statement. A second, amended registration statement is subsequently filed, reflecting changes in accordance with the SEC comments. It is not uncommon for first-time issuers to receive a deficiency letter even as to amended registration statements. Indeed, the first registration statement that I worked on as a young associate in a law firm generated five such letters, partly as a result of my own inexperience and partly because the company was engaged in an unprofitable foreign business for which the SEC staff demanded considerable supplemental information. The SEC's guidelines for deficiency letters are codified in 17 C.F.R. § 202.3(a) (1999).

"Please do that, Horace," Orville said. "If we don't leave soon for North Carolina, we'll miss the season. Another year could mean we've lost the lead on the French and Germans."<sup>105</sup>

"Boys, I'll do what I can," Horace replied, none too confidently.

*Epilogue: Kitty Hawk, North Carolina, December 1903*

The winds were calm on this 14th day of December, too calm in fact to permit a start from level ground. The Flyer was towed a quarter of a mile to the top of Kill Devil Hill. The truck that would propel the craft to its rolling start, and the rails along which the craft would run, were placed downward along the hill. Wilbur won the coin toss and climbed onto the lower wing. Orville spun the right propeller and cranked the motor, which started immediately. As the truck moved downhill, pushing the craft with it, Orville ran along the side, steadying the wings. After thirty-five to forty feet, the restraining wire to the truck was released and the Wright Flyer took flight. Wilbur turned the machine upwards too quickly. The Flyer stalled and sunk to the ground, cracking one of the skids and several other parts. The first flight had lasted 3.5 seconds. Indeed, it could not technically be considered a flight, as it landed at the base of the hill, lower than the point at which it took off.

Repairs and calm winds kept the brothers from further attempts for several days. The calm ended on December 17. Ice was scattered in pools along the ground, the sky was grey, and winds were gusting from the north stronger than Orville and Wilbur would have liked. They waited in vain several hours for the winds to slacken. Their patience gone and eagerness rising, the brothers decided to attempt another flight. The Flyer was wheeled out of its shed. The sixty-foot starting track was laid along the level ground and the craft positioned upon the track, facing into the wind. At 10:35 a.m., Orville (it was now his turn) hoisted himself onto the craft and laid down across the lower wing, his hips resting in a cradle that contained the control mechanisms. Wilbur cranked the engine, and the truck started forward, pulling the Flyer along. Wilbur ran alongside, holding a wing to keep the craft balanced. Forty feet down the track, the Wright Flyer rose slowly and climbed to a height of approximately ten feet. Orville had difficulty controlling the craft in the strong winds. After a roller coaster up-and-down flight of twelve seconds, covering 120 feet, the craft dropped abruptly to the ground. It was not graceful, but it was historic. An hour later, Wilbur duplicated the feat with a flight of 175 feet. The brothers completed four flights that day and looked forward to longer and higher flights in days to come. Unfortunately, while the craft was standing near its shed at day's end, a gust of

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<sup>105</sup> The brothers were well aware of other flight experimenters and that they were part of an unofficial race to be the first to fly an engine-powered machine. They once admonished Chanute for his wide distribution, including overseas, of the text of a talk given by Wilbur in 1901 in Chicago. CROUCH, *supra* note 1, at 230.



wind struck it sidewise, turning it over several times. The damages were too extensive to be repaired and the first Wright Flyer never flew again. The brothers returned to Dayton shortly thereafter. They were never to return to Kitty Hawk. Future flights were conducted in the Dayton area and elsewhere.

And what of the financing problems? Fortunately, that element of this historical account was fictional. But what if a need for funds had existed? The story might well have ended differently. Having been rejected on merit grounds from offering shares in Ohio and other mid-western states, the Wrights would have turned to New York as their only hope. Yet they could not have begun an offering in New York until the registration statement became effective with the SEC. Delays at the federal level could be easily conjectured. The initial SEC comment letter had asked for backup engineering data and more detailed explanation of the profit-making capability of a flying machine. The information supplied might not have satisfied the examiners. The SEC could be expected to be cautious, given the novelty of the venture and the lack of clear profitability. A second comment letter could well have resulted. It might have required the prospectus to delete all references to potential government contracts unless such contracts were in fact being negotiated. It might have required a much more complete description of potential uses of a flying machine for profit-making purposes. It might have required the prospectus to describe what additional funding might be available if the company could not generate revenues. These and other inquiries would all be in the name of full disclosure, although it would be apparent that the full disclosure gambit was an indirect form of merit review. The SEC might not be able to foreclose a risky offering, but it could certainly delay it and cause the promoters to jump through innumerable hoops. Multiple SEC comment letters, and the time necessary to gather responsive information, might have stalled the offering beyond the time that the Wrights could leave for North Carolina. They were prepared to brave the winds and cold of November and December, but not the icy conditions of January through March. The 1903 experiments might have been postponed. What would have been the effect of the delay? Samuel Langley was working diligently on flight experiments,<sup>106</sup> as were French and German inventors experimenting with power-driven craft. The world was on

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<sup>106</sup> In 1896, Samuel P. Langley built a power-driven glider that flew over the Potomac River near Washington, D.C. The flight, which lasted approximately a minute and a half, marked the first time that a power-driven, heavier-than-air machine stayed in the air for more than a few seconds. Langley was the Secretary of the Smithsonian Institution in Washington, and his success sparked enormous interest in the possibility of flight. (The Smithsonian provided the Wrights with their initial books and pamphlets describing flight experiments and glider construction, responding to a request from Wilbur in June 1899, as the brothers were beginning the development process.) Langley continued his work on mechanical flight, urged on by interest from the War Department. Two 56-foot machines were built in 1903, but both failed.

the verge of motor-powered flight, but it might not have been the Wright brothers who first rose into the air to become icons of American history.

### III. IMPEDIMENTS TO CAPITAL FUNDING

The Wright brothers saga, albeit fictionalized, illustrates the regulatory limitations that severely inhibit the capital-raising prospects of small and start-up companies. One must question whether the efforts of countless entrepreneurs, inventors, and dreamers who struggle to find outlets and financing to support their ingenuity are in fact hindered, or even defeated, by the securities laws. Has the concern for investor protection led to a regulatory regime in which both tangible and intangible costs have become too high? Statistics are not available regarding the number of start-up or near start-up companies that fail for lack of an ability to raise adequate capital, or whether such failures are in part due to the legal strictures of raising capital. What we do know is that the securities laws do not facilitate capital funding for smaller companies. Despite the growth of state- and SEC-authorized exemptions, legislative policy continues to reflect the fundamental view that registration exemptions are exceptional and not easily attainable.

A history of more than sixty years of securities regulation should give an indication of which of our regulatory processes are most significant. Viewed from that perspective, one must question whether the registration requirement, the heart of both federal and state securities legislation, should remain the primary investor protection process. Put another way, if disclosure is the *sine qua non* of the securities laws, it might be preferable to reduce emphasis upon registration, expand exemption possibilities, and concentrate on measures that promote full disclosure and sanction disclosure violations.

The menu of registration exemptions is tantalizing but, upon close examination, seriously flawed. Securities law problems faced by entrepreneurs seeking to utilize such exemptions fall into the following principal areas:

#### A. *Limitations on Manner of Offering*

Every federal exemption creates substantial marketing problems. Rule 504 prohibits general solicitation and advertising unless the offering is registered under state law or is offered under a state exemption that allows general solicitation and advertising for offerings limited to accredited investors.<sup>107</sup> In addition to these state law considerations, Rule 504's ceiling is too low. Limiting developing companies to no more than \$1 million every twelve months is a serious restraint for many start-ups, especially in technology and health areas, where high personnel and research costs are involved.

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<sup>107</sup> See *supra* note 39.

Although the intrastate exemption has the advantage of allowing solicitation and advertising within the state in which the offering is made, this exemption is riddled with technical limitations. The exemption is lost even if one out-of-state person is offered the security, regardless of the company's good faith. The offer alone ruins the exemption. Indeed, it does not matter whether the out-of-state offeree purchases the security. The exemption is also lost if prior or subsequent investments by out-of-state investors are deemed integrated into the state offering (the problem that the Wright brothers faced with their sales to Octave Chanute). Moreover, the ambiguous statutory standards of section 3(a)(11) and the more objectively stated criteria of Rule 147 both demand a truly localized business. Any significant degree of out-of-state business could ruin the exemption, a limitation that is archaic in light of the increasingly interconnected national and global economies. One might be more sympathetic to the exemption's limitations if there were merit to the notions that local investors know management and understand the local business, and that local enforcement can quickly discover and respond to offering violations. But those concepts make sense only in the smallest communities. When applied in states with millions of dispersed citizens ranging over hundreds of miles, concepts based upon local knowledge and control are no longer justifiable. At a minimum, consideration should be given to creating a regional exemption covering multiple states<sup>108</sup> or permitting some percentage leeway for out-of-state investors.

The private offering exemption qualifications for offerees and purchasers limit the pool of potential investors and, when coupled with the stringent limitation against advertising and solicitation,<sup>109</sup> make it extremely difficult for start-up companies to find a sufficient number of investors to meet their capital requirements. The principal hope for many young enterprises is to attract the interest of either a well-heeled angel<sup>110</sup> or a venture capital company. In that case, only one investor

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<sup>108</sup> This suggestion was one of several developed by the SEC's 1996 Task Force on Disclosure Simplification (available on the SEC's Internet web site <<http://www.sec.gov/rules/propridx.htm>>). That suggestion was not adopted, nor was any other affecting the intrastate exemption. The only exemption reforms adopted from the Task Force report involved elimination of relatively insignificant reporting forms. See Phase Two Recommendations of Task Force on Disclosure Simplification, 62 Fed. Reg. 39,755 (1997).

<sup>109</sup> See *supra* notes 47-48, 50-52, 64, 67-68 and accompanying text.

<sup>110</sup> The term "angel" has become the securities industry appellation for an individual who is a significant financial backer of a young enterprise, usually in lieu of a venture capital company. Angel financing is more common and larger in total cumulative amounts than funding by venture capital companies, as many capital-seeking enterprises find it easier, quicker, and cheaper to solicit and contract with wealthy individuals rather than undertake the extensive and often frustrating search for a willing venture capital firm. Angels are not on every street corner (real or ethereal), but there is a growing body of wealthy entrepreneurs willing to invest in start-ups in the hopes of finding the next big market attraction, and many law firms and accounting firms are able to provide clients with names and ready access to such

need be found, albeit an investor that brings with it a set of demands that substantially affect management and long-term goals. Venture capital is a welcome source of funding in some instances, but many start-ups never make it to first-round consideration. Companies outside of the current "hot" field stand little hope of consideration. What is "hot" varies over time. Computer technology, medical care, and high-tech communications have been venture capital darlings in the recent past. But being in the right field is not enough. Unless the prospects are bright for an Initial Public Offering (IPO) within a few years, which means rapid and substantial revenue growth, even the most well-managed companies will not get their feet in an angel's or venture capitalist's door. Without a prospect for a major investor, companies hoping to use the private offering exemption often will be substantially hampered by unbending requirements regarding offering methods and offeree and purchaser qualifications.

The Regulation A exemption relaxes some of the solicitation limitations and imposes no restrictions on offerees or purchasers. Yet Regulation A is not amenable to many start-up or developing situations. The monetary limit of \$5 million is too low in many instances. The modified registration process is both costly and time-consuming and could result in delays during periods that companies have substantial fiscal needs. The "test-the-waters" provisions are a major step in the right direction,<sup>111</sup> but so far only a relatively few states permit solicitation in the absence of a locally filed registration statement.<sup>112</sup> Indeed, most states do not exempt Regulation A offerings from state registration. Thus, companies will need

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individuals. See generally, Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 62 (1998) (noting the role of business angels as an informal source of capital which fills a "gap between start-up funds and other capital sources"); Rich Karlgaard, *Manager's Journal: Dollars from Heaven*, WALL ST. J., Mar. 16, 1998, at A22 (noting the rise in and advantage of angel financing compared to venture capital financing).

<sup>111</sup> Rule 254, 17 C.F.R. § 230.254 (1999). Issuers may solicit expressions of interest before filing the offering statement under the following conditions: (a) a written solicitation of interest document must be delivered to prospective investors before any oral communication, (b) no money or commitment may be accepted, and (c) no sales can be made until qualification of the offering and not until at least twenty days after delivery or publication of the solicitation of interest document. The SEC's adoption of the "test-the-waters" concept in 1992 was a major turnaround from prior no-solicitation positions.

<sup>112</sup> Arizona, ARIZ. ADMIN. CODE § 14-4-141 (1999); Colorado, Colo. Div. Sec. Rules § 51-3.13A, 1A Blue Sky L. Rep. (CCH) ¶ 13,430C, at 9,406 (1999); Indiana, IND. ADMIN. CODE tit. 710, r. 1-13-7 (1999); Kansas, KAN. ADMIN. REGS. 81-5-12; Massachusetts, MASS. REGS. CODE tit. 950, § 14.402(k) (1999); North Dakota, N.D. CENT. CODE § 10-04-06 (1999); Oregon, OR. ADMIN. R. 441-35-045 (1999); Pennsylvania, Availability of Discretionary Exemptive Order, 3 Blue Sky L. Rep. (CCH) ¶ 48,684J, at 43,689-106 (1999); Utah, UTAH ADMIN. CODE R164-14-21s (1999); Virginia, VA. ADMIN. CODE § 5-40-70 (1999); Vermont, Exemption Order, 3A Blue Sky L. Rep. ¶ 58,430, at 51,613 (1999); Washington, Washington State Department of Financial Institutions—Securities Division, *Testing the Waters: Solicitation of Interest* (visited Oct. 8, 1999) <<http://www.wa.gov/dfi/securities/ttw.html>>; Wisconsin, Wis.

to go through state registration if they cannot fit the offering into a state exemption.

### *B. Integration with Other Offerings*

Developing companies frequently need capital input. The hiring of research and development personnel, the purchase of equipment, the need for expanding facilities, and other capital demands often arise with little advance warning. Because developing companies generally have little or no revenue from operations, they are funded solely by additional debt or equity inputs. Debt financing might be possible, and loans from major institutions might not be deemed securities. However, many smaller companies cannot finance more than a small portion of their needs from traditional lending sources. Consequently, the securities market is often the only source for additional capital. But when a company goes back to the securities market on multiple occasions, it runs the substantial risk of invoking the integration doctrine.

The basis of integration is that a single offering should fit within a single exemption. An issuer should not split a single offering into smaller parts that fit particular registration exemptions only on a piecemeal basis. The integration doctrine is problematic on two fundamental points. First, the premise that an offering cannot be split into discrete parts is related only to form, rather than substance. The inquiry for any offering should be whether the prospective investor was afforded adequate protections against an abusive offering. Integration does not address that issue. It simply is a formalistic barrier to capital raising.

To use the Wright brothers scenario as an example, if the Wrights had obtained funding from Octave Chanute and several other investors, all of whom qualified as knowledgeable investors under the private offering exemption, why should the Wrights have been precluded from engaging in a concurrent offering to other investors under Rule 504? If all prospective investors are accorded whatever safeguards a particular exemption requires, the integration doctrine adds nothing to the goal of investor protection.

A second fundamental problem with the integration doctrine is the difficulty of ascertaining a single offering.<sup>113</sup> The five-part test developed by the SEC<sup>114</sup> leaves much room for differing interpretations. When a developing company raises money to finance research efforts, and then

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ADMIN. CODE § 2.027 (1999); Wyoming, Wyo. Sec. Div. Reg. ch. 6, § 2(f), 3A Blue Sky L. Rep. ¶ 66,433 (1999).

<sup>113</sup> See Cheryl L. Wade, *The Integration of Securities Offerings: A Proposed Formula That Fosters the Policies of Securities Regulation*, 25 LOY. U. CHI. L.J. 199, 200 (1994) ("[B]ecause the test lacks clarity, it is frequently impossible to predict whether an issuer's offerings will be integrated.") (footnote omitted). Professor Wade recommends that the integration doctrine not be applied if the issuer can demonstrate a rational business purpose for making the separate offerings.

<sup>114</sup> See *supra* note 57.

does the same several months or even many months later, are the two fundraising efforts part of a "single plan of financing"? What is deemed a "plan" for these purposes? Developing companies inevitably require repetitive capital inputs. Does the inevitability element cause multiple offerings to be part of a "single plan of financing" or to be offerings "made for the same general purpose"? The lack of a ready answer to this question creates enormous risk for companies who are faced with the Hobson's choice of risking a violation of the securities laws or foregoing much-needed capital funding.<sup>115</sup>

The integration rules are ameliorated to some extent by the six-month safe harbors created for Rule 147<sup>116</sup> and Regulation D<sup>117</sup> offerings. Regulation A also provides fairly clear safe-harbor standards.<sup>118</sup> However, the six-month bright-line tests create their own set of problems. For one, the measuring point for the time period starts only with the completion of the prior offering, which raises interpretive questions as to when a prior offering (as opposed to sales) has ended. Indeed, when smaller companies engage in financing efforts, they might do so in a manner that makes an offering's "completion" date somewhat uncertain, thus further exacerbating planning efforts. The six-month time period is also problematic. Although there is no explicit presumption in any SEC rule that offerings within six months are integrated, the creation of a fixed-boundary date could cause courts and counsel to treat such offerings as presumptively integrated unless clearly proven otherwise. Finally, the six-month cleansing period may be far too long for many young companies to wait before they can raise additional capital.

### C. *Restrictions on Solicitation*

No limitation characterizes the phobia of securities regulators more than the prohibitions against general advertising and solicitation.<sup>119</sup> Developed in the early history of the private offering exemption<sup>120</sup> and codified in regulation D,<sup>121</sup> the proscription against broad-based efforts to find potential investors has remained a bulwark of federal and state securities laws.

As the antisolicitation rules are applied, companies engaged in private offerings under section 4(2) or Rule 506, Rule 505 offerings, or any

<sup>115</sup> The problem also creates ethical dilemmas for companies' counsel. See *supra* note 87.

<sup>116</sup> Rule 147(b)(2), 17 C.F.R. § 230.147(b)(2) (1999).

<sup>117</sup> Rule 502(a), 17 C.F.R. § 230.502(a) (1999).

<sup>118</sup> Rule 251(c), 17 C.F.R. § 230.251(c) (1999).

<sup>119</sup> For a critique of the SEC's antisolicitation rules, see Stuart R. Cohn, *Securities Markets for Small Issuers: The Barrier of Federal Solicitation and Advertising Prohibitions*, 38 U. FLA. L. REV. 1 (1986); Daugherty, *supra* note 64, at 67.

<sup>120</sup> See *supra* note 52.

<sup>121</sup> Rule 502(c), 17 C.F.R. § 230.502(c) (1999) ("[N]either the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising . . .").

of a wide variety of offerings under state exemptions, must refrain from advertising the fact of the offering to the general public or any segment thereof. They cannot utilize even tombstone-like notices that do no more than invite interested persons to make further inquiry and receive an offering document. Even the most innocuous notice of a pending offering is likely to be deemed an "offer."

It is difficult to understand what harm results from a brief notice advising that a company is offering its securities and inviting inquiries from interested persons. If persons who respond are given full disclosure before any investment decision is made, there appears to be no public policy basis for denying the company the opportunity to attract such persons. If the concern is that advertisements and notices can "pre-sell" investors regardless of ultimate disclosures, the appropriate response is not to ban legitimate efforts to attract potential investors but to regulate the quality of disclosures that may be made in a solicitation setting.<sup>122</sup>

The second arrow in the antisolicitation bow relates to interaction with potential investors. Person-to-person contact is extremely important to smaller companies because they have neither the name recognition nor the established goodwill to draw on a ready pool of potential investors. Yet personal solicitation is prohibited except in the narrow circumstances where the company or its agents have a prior relationship with the individual being solicited.<sup>123</sup> Further, the prior relationship must predate the current offering and be sufficient to allow the company or its agent to know that the person being solicited can understand the merits of the offering and afford the economic risk.<sup>124</sup> Without a major benefactor or a willing venture-capital partner, developing companies have little chance to attract investors without running afoul of the solicitation restraints. The SEC cracked open the antisolicitation door for issuers who employ broker-dealers.<sup>125</sup> However, offerings by small companies usually are too small or limited in scope to interest even local or regional broker-dealers.

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<sup>122</sup> A recent example of the SEC's form-over-substance stance is found in *Mobile Biopsy, LLC*, SEC No-Action Letter, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,613, at 76,157 (Aug. 11, 1999). In order to raise funds for medical equipment, an LLC proposed mailing circulars to local surgeons and radiologists who would be expected to be knowledgeable about the services and potential users. Any potentially interested investors would return a card indicating their interest, and they would then be provided a complete disclosure document. The offering was intended to comply with Rule 506 of Regulation D. However, SEC staff denied the no-action request, stating that the initial mailing would be a prohibited "general solicitation" under Rule 502(c). It is difficult to understand why the rule-oriented formalism should continue to prevail over examination of the quality of disclosure and investor understanding.

<sup>123</sup> See *supra* note 64.

<sup>124</sup> See *supra* note 66.

<sup>125</sup> Broker-dealers are permitted to solicit from lists of prequalified customers. See E.F. Hutton & Co., SEC No-Action Letter (Dec. 3, 1985), available in LEXIS 2917; Arthur M. Borden, Esq., SEC No-Action Letter (Oct. 6, 1978), available in LEXIS 2001.

## IV. REFORM WITH AN EYE ON INVESTOR PROTECTION

Any effort to ameliorate offering conditions for small and developing companies must include the consideration of investor protection. But what precise protections are necessary for investors? Viewing the federal and state registration processes in their most essential aspects, what investor protection is afforded by policies that promote registration of securities offerings? Peeling away the layers of registration requirements reveals two fundamental protective elements. These elements are noted by the SEC in its "Aircraft Carrier" Release,<sup>126</sup> namely that the registration system "provides investors with the dual benefits of: full and fair disclosure (or effective remedies if there is faulty disclosure), and freely tradable securities."<sup>127</sup> This statement is revealing. The SEC finds two principal benefits from registration—disclosure and the ability to resell securities. For investors willing to acquire restricted, rather than freely tradable, securities,<sup>128</sup> the benefit of full disclosure backed by sanctions can be achieved as effectively through exemption requirements as through registration.<sup>129</sup> Although registration involves SEC review, no amount of administrative review can guarantee compliance with disclosure requirements. If, as the SEC indicates, disclosure is the principal element in a registration scheme, and if disclosure can be provided effectively in an exempt offering, there is little reason other than antipathy to the exemption process to load exemptions with numerous additional and often highly technical elements.

One may agree with Professor Jonathan Macey that the SEC has disrupted the capital formation process through inefficient regulations without necessarily accepting his conclusion that the SEC suffers from

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<sup>126</sup> Regulation of Securities Offerings, Securities Act Release No. 7606A, Exchange Act Release No. 40632A, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,108, at 81,461-3 (Nov. 13, 1998).

<sup>127</sup> *Id.* ¶ 86,108, at 81,467.

<sup>128</sup> See, for example, Rule 502(d), 17 C.F.R. § 230.502(d) (1999), which limits the resale of securities acquired in Rule 505 or Rule 506 exemptions. Such securities, along with securities acquired in a private offering, are deemed "restricted" securities and may be resold in accordance with Rule 144, 17 C.F.R. § 230.144 (1999).

<sup>129</sup> Registered offerings subject the company, its directors, principal officers, and certain others to section 11 liability, a liability that is strictly applied against the issuer and turns on the defense of due diligence for the individual defendants. See *Escott v. Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Disclosure violations in exempt offerings are not subject to section 11 and can be tried only under the more limited provisions of section 12(2) of the 1933 Act and Rule 10b-5 under the 1934 Securities Exchange Act. It may therefore be argued that disclosure cannot be as effectively mandated in exempt offerings because of the different and more conditioned sanctions. The difference may be more one of form than substance. The lack of due diligence that dooms a section 11 defendant may not be much different from "recklessness" that likewise undermines the Rule 10b-5 defendant. Similarly, in smaller companies many of the principal officers and directors are likely to be directly involved in the selling process, thus subjecting themselves to liability under section 12(2) as sellers or under Rule 10b-5 as primary violators.



obsolescence, agency imperialism, and capture by special interest groups.<sup>130</sup> None of the examples cited by Professor Macey demonstrating the SEC's supposed obsolescence relate to initial capital formation, except for his discussion of the efforts to limit trading in penny stocks.<sup>131</sup> Penny stock trading is a specialized area that has witnessed enormous abuse in both the primary and secondary markets. I do not agree that the SEC's lack of development of effective registration exemptions is a result of imperialistic desires over the capital market or a surrender to securities professionals who benefit from a mandated registration process. In my judgment, the failure has simpler roots.

The Commission is the repository of countless investor complaints stemming from failed (and often unregistered) investments. Its Enforcement Division is incapable of pursuing more than a small fraction of potential 1933 Act violations. The agency was born with a heritage demanding concern for the individual investor. The collective weight of these factors has led to a systemic, inherent, and structural bias against lowering the bar for registration.

When the Commission does lower the bar, it does so only by inches. Witness Rule 504,<sup>132</sup> the most liberal of all federal exemptions. It is limited to \$1 million,<sup>133</sup> a figure far too low to accommodate many of today's technical start-up companies. Witness also the amendment to Regulation A authorizing issuers to "test the waters" before committing to the time and expense of a Regulation A offering.<sup>134</sup> The SEC should have known when the concept was adopted that it was of little practical merit because few states would permit such solicitation in the absence of state registration.<sup>135</sup> Similarly, on the surface, Rules 505 and 506 offer great latitude to issuers who offer securities to accredited investors,<sup>136</sup> but small and developing companies are hamstrung from attracting such investors by stringent antisolicitation provisions. The grudging SEC concessions over the years are evidence that the SEC fears exactly what state administrators fear at the local level: the creation of an unregulated process that is an open invitation to the unscrupulous to prey on the unsuspecting.

However laudatory the federal and state concerns for the innocent investor, today's highly regulated regime actually offers scant protection to vulnerable, inexperienced, would-be investors. Fraudulent offerings

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<sup>130</sup> Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994).

<sup>131</sup> *Id.* at 945-48.

<sup>132</sup> Rule 504, 17 C.F.R. § 230.504 (1999).

<sup>133</sup> See *supra* note 3.

<sup>134</sup> Rule 254, 17 C.F.R. § 230.254 (1999).

<sup>135</sup> See *supra* note 112 and accompanying text.

<sup>136</sup> There are no formal disclosure requirements for offers to accredited investors, such investors are not counted in the total number of permitted purchasers, and such investors are deemed sophisticated for Rule 506 qualification purposes. Regulation D, 17 C.F.R. §§ 230.501-.508 (1999).

are rarely, if ever, registered.<sup>137</sup> Perpetrators know better than to submit themselves to preoffering scrutiny. Unregistered offerings are made with absolute effrontery to the securities laws. They are successful in many instances because the promoters are shrewd, their methods clever, and their investors trusting. The registration system is irrelevant to such promoters and thus provides no protection to investors. If and when fraudulent schemes are detected and brought to a halt by administrators, all too often the perpetrators have fled and few assets remain. To charge the promoters at that point with the strict liability offense of nonregistration makes the prosecutors' job easy, but does nothing to recover lost investments. Moreover, fraudulent schemes invariably are so deficient in disclosure that prosecution for disclosure violations also presents no substantial difficulties. Thus, enlarging the field of potential nonregistered offerings does not create a greater risk of unworthy or fraudulent offerings; it simply shifts the prosecutorial focus from registration to disclosure.

Where should reform begin? The following seven considerations should be placed at the forefront:

(1) Eliminate restraints on solicitation and advertising. Promotional statements and sales tactics used to attract investors before a disclosure document is provided should be subject to well-defined liability standards.<sup>138</sup>

(2) Raise the limit for Rule 504 offerings to \$10 million and Regulation A to \$20 million.<sup>139</sup> The current limits are so low as to be unworkable for many companies.

(3) Exempt Rule 504 and Regulation A offerings from state registration. The preemption door was opened a crack for Rule 506 offerings in 1996.<sup>140</sup> It is time to widen the opening in order to avoid the left-hand-

<sup>137</sup> See, for example, COMPTROLLER'S TASK FORCE ON SECURITIES REGULATION, STATE OF FLORIDA, REPORT (1986) (on file with author), regarding major securities frauds in the state, none of which was registered at the federal or state level.

<sup>138</sup> See Langevoort, *supra* note 63, at 25 (suggesting the elimination of the antisolicitation provisions in favor of a testing-the-waters approach followed by a cooling-off period between initial solicitations and ultimate sales).

<sup>139</sup> It appears that the SEC has authority under section 28 of the 1933 Act, 15 U.S.C. § 77z-3 (Supp. III 1997), to broaden exemption limits without an express amendment to section 3(b) of the 1933 Act, 15 U.S.C. § 77c(b) (Supp. III 1997), increasing the statutory \$5 million limit in that provision's grant of authority to the SEC to create registration exemptions.

<sup>140</sup> See *supra* note 83. The preemption of a registration philosophy that has existed for nearly ninety years will not be an easy political task. Many state administrators would agree with Professor Manning Warren:

Experience indicates . . . that offerings exempted from advance SEC scrutiny are more likely to be fraudulent or highly speculative than offerings subject to registration. Given the large number and the tremendous volume of securities exempted from federal registration, investor protection cannot be maintained without review of these offerings by authorities at the state level.

Manning G. Warren III, *Reflections on Dual Regulation of Securities: A Case Against Preemption*, 25 B.C. L. REV. 495, 528 (1984) (footnote omitted). One might be more sympa-

giveth-and-right-hand-taketh-away syndrome of concurrent federal and state jurisdiction.<sup>141</sup>

(4) Eliminate Rule 505. If the reforms are made as suggested, there will be no need for this technical and limited exemption.

(5) Eliminate the disclosure distinction between accredited and nonaccredited investors. All registration exemptions should be premised on providing full disclosure to all investors, regardless of sophistication or wealth.

(6) Eliminate the "sophistication" requirement for private offerings. Persons of ordinary intelligence should be allowed to act on their own when given adequate information. Issuers should refrain only from selling securities to persons who they know or reasonably should know do not understand the nature or risks of the offering.

(7) Eliminate the integration doctrine or substantially enlarge the safe harbor for smaller companies that have continual capital demands. Elimination of the doctrine would not obviate the need for the issuer to comply with an appropriate exemption for each offering.

The list is not exhaustive. Reforms to the registration process could make the process quicker and less costly. The SEC currently is proposing far-reaching reforms to assist large, well-seasoned companies.<sup>142</sup> But large and established companies are not the ones facing procedural difficulties in raising capital. One of the few bones thrown to small issuers among the current proposals eases the ability to abandon a registered offering in order to pursue a private offering.<sup>143</sup> Although some issuers may take advantage of this easing of the traditional integration doctrine,<sup>144</sup> the proposal offers little to small companies, as it still requires the initial time-consuming and costly effort of preparing and filing a registration state-

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thetic to Professor Warren's argument if promoters of fraudulent and questionable schemes regularly submitted their offerings to administrative scrutiny. The evidence suggests otherwise.

<sup>141</sup> The proposed preemption of state law, coupled with elimination of antisolicitation rules, raises the "pump and dump" concerns recently expressed by SEC staff that led to recent amendments to Rule 504. *See supra* note 81. The "pump and dump" syndrome succeeds only with the aid of improper market manipulation by broker-dealers. It is not at all clear why the fraudulent activities could not be adequately policed through effective enforcement against broker-dealers. Requiring issuer registration in each state increases costs and burdens on small companies, those most in need of the Rule 504 exemption.

<sup>142</sup> Regulation of Securities Offerings, Securities Act Release No. 7606A, Exchange Act Release No. 40632A, [1999 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,108, at 81,461-3 (Nov. 13, 1998).

<sup>143</sup> *Id.* at 81,555-81,556. A proposed safe harbor would permit switching from a registered public offering to a private offering. Disclosure liability would vary depending on whether the private offering comes within or after thirty days following abandonment of the registration.

<sup>144</sup> Rule 152, 17 C.F.R. § 230.152 (1999), permits private offerings to precede public offerings without the consequences of integration. The SEC's current proposal also would allow private offerings after a registration has been withdrawn.

ment. For those concerned with the capital-raising problems of small business, the SEC's current efforts to ameliorate restrictions for large and established companies is an alarming sign that reform attention is concentrated on the wrong end of the spectrum.

## V. CONCLUSION

Statistical evidence does not exist regarding the extent to which small and developing companies have been impeded by federal and state securities laws from raising capital in a timely and sufficient manner. One indicium of the demand for capital is the large number of companies that submit funding proposals to venture capital firms. Given the fact that such firms insist upon sizeable equity positions and a substantial voice in company management, the willingness of many fledgling enterprises to submit themselves to venture capital investment may reflect the lack of adequate alternatives in the capital market. If the securities laws made it easier for such companies to solicit and obtain investors, the venture capital route might not be as attractive. Except for that indicium, and anecdotal evidence gathered each year at the SEC Small Business Forum,<sup>145</sup> it is possible only to surmise the negative impact of the securities laws upon small business formation and development.

While one may be uncertain as to statistical evidence regarding the hardships imposed by the current regulatory scheme, there likewise is a lack of hard evidence regarding the amount of fraud prevented by the registration and exemption processes. There can be no question that fraudulent investment schemes abound and, perhaps, have risen in number with the advent of the Internet. Such schemes do not bother with registration or the niceties of exemption conditions. The registration requirement has not deterred fraud; it simply has created a convenient cause of action for nonregistration when and if the fraud is discovered and the perpetrators apprehended. What registration does provide is an extensive disclosure document. Yet equally effective disclosure often is achieved in nonregistered offerings through private placement memoranda and similar disclosure documents.<sup>146</sup> The impetus for disclosure in the nonregistered setting is compliance with exemption conditions and effective sanctions. If disclosure, which is at the heart of the registration process, were also the dominant condition for registra-

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<sup>145</sup> See *supra* note 6.

<sup>146</sup> It will be argued by some that easing the regulatory requirements will create opportunity for an increase in sham or fraudulent offerings. The response, I believe, is twofold. First, those bent on deceptive offerings do not adhere to formal requirements, whatever they may be. Second, preventive measures aimed at occasional fraudulent offerings are imposing unreasonable transaction costs upon the vast majority of issuers managed by honest and well-intentioned promoters. Deceptive and improper offerings should be sanctioned through disclosure standards and effective enforcement processes. The registration standard is not a necessary, nor under the circumstances an appropriate, vehicle for addressing the concern.

tion exemptions, the numerous other technicalities imbedded in the various exemptions could be eliminated or substantially modified.

A former SEC Chairman once noted that "[a]lmost every new technology that has given a lift to the American economy has come from a new company, struggling in a garage or venturing out to obtain needed capital from the public."<sup>147</sup> Whether located in garages or bicycle shops, young enterprises require continuous financial nourishment. The likes of the Wright brothers do not come around often, judged by their ingenuity and ability to invent on the proverbial shoestring. In today's highly technological environment, the Wright brothers' counterparts and other would-be inventors generally require access to substantial capital. Our federal and state securities laws not only fail to adequately address that concern, the regulatory process impedes efforts to attract potential investors. Access to capital could be facilitated by substantial revision of exemption and registration requirements without abating existing disclosure requirements. The SEC has created an impressive stir with its Aircraft Carrier proposals addressed to large, well-established companies.<sup>148</sup> Entrepreneurship in this country would be better served by equal attention to the more numerous and needy firms at the other end of the business spectrum.

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<sup>147</sup> William J. Casey, *SEC Rules 144 and 146 Revisited*, 43 BROOK. L. REV. 571, 572 (1977).

<sup>148</sup> See *supra* note 7.